

*United States Court of Appeals  
for the Second Circuit*



**BRIEF FOR  
APPELLEE**



76-6175

[Printed Version]

UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

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SECURITIES AND EXCHANGE COMMISSION,  
Plaintiff-Appellee,

v.

COMMONWEALTH CHEMICAL SECURITIES, INC., et al.,  
Defendants-Appellants.



Appeal from the United States District Court for the  
Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

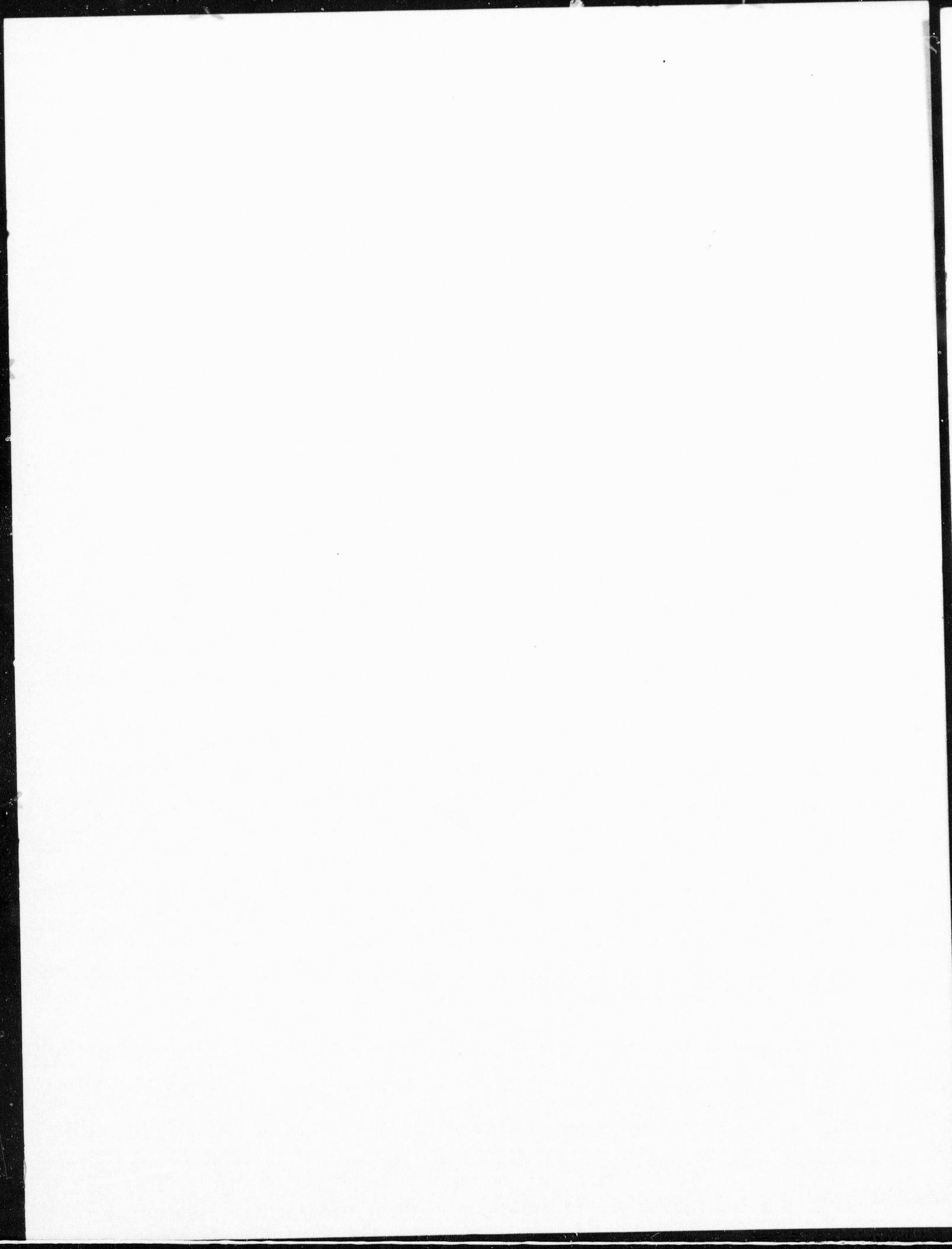
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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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COUNTERSTATEMENT OF QUESTIONS INVOLVED

1. The two principal individual appellants controlled a registered broker-dealer, and a registered investment adviser, which served as adviser to two registered investment companies of which these individuals were officers and directors.

(a) When the broker-dealer was underwriter for a 50,000-units-or-nothing public offering (that is, unless 50,000 units consisting

of stocks and warrants should be sold within 90 days, all purchased monies would be refunded), but conducted the closing when the proceeds of 50,000 units had not been placed in a special account, as represented in the offering circular and required by a Commission rule, and when a large number of units had been placed in nominees' accounts under unusual circumstances and were repurchased by the broker-dealer a few weeks later, were the District Court's findings "clearly erroneous" that, contrary to appellants' representations, the required 50,000 units had not been sold at the time of the closing and that this was known by the principal appellants?

(b) When the price of the stock doubled within a few days after the closing and increased six-fold within six months (and similar price increases occurred in the units and warrants) for no apparent economic reason; when the appellants participated, inter alia, individually and through controlled accounts, in a substantial majority of the trading transactions involving the securities and were on both sides of nine percent of the stock transactions; and when the principal appellants, through intermediaries, sold large blocks of the securities to the two registered investment companies, was the District Court's finding "clearly erroneous" that appellants' manipulated the market for these securities?

(c) In the light of the large blocks of these securities the principal appellants sold without Commission approval to the investment companies (more than 20 percent of the assets of one investment company and more than 60 percent of the assets of the other were invested in these securities) of which the principal appellants' corporation was investment adviser, was the District Court's finding "clearly erroneous" that they had violated the provisions of the Investment Company Act that forbid transactions between registered investment companies and their affiliates without Commission approval and of the anti-fraud provision of the Investment Advisers Act that forbids advisers from recommending the purchase of securities without disclosing their interest to their clients?

2. In the light of the foregoing, did the District Court abuse its discretion:

(a) in enjoining not only the two principal appellants, their broker-dealer company and their investment adviser company, but also the two other appellants, one of whom, the broker-dealer's bookkeeper, opened one of the nominee accounts relied on for the closing and then traded in the securities at a substantial profit during the manipulation, and the other, the wife of one of the principal appellants, also, consistently throughout the manipulation, participated in the trading during the manipulation at a substantial profit?

(b) In requiring, as ancillary relief, that all appellants disgorge their profits?

3. Were appellants entitled to a jury trial because the Commission sought disgorgement of their profits resulting from their unlawful activities as ancillary relief?

4. Did the District Court follow appropriate methods in determining the amount of appellants' profits?

COUNTERSTATEMENT OF THE CASE

Introduction

This is an appeal from a judgment, entered by the United States District Court for the Southern District of New York, on September 30, 1976, 1/ that permanently enjoined the appellants and other defendants, in an action brought by the Securities and Exchange Commission, from violating provisions of the federal securities laws and rules of the Commission that prohibit fraud in the sale of securities 2/, the manipulation of securities markets 3/, and self-dealing by persons affiliated with

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- 1/ The district court issued two opinions prior to the judgment in this action. The first opinion is reported at 410 F. Supp. 1002 (S.D. N.Y., 1976). The second opinion is reported at [1976-77] CCH Fed. Sec. L. Rep. ¶95,741 (S.D. N.Y., 1976). References herein to the slip opinions are denoted "Op. I \_\_\_\_" and "Op. II \_\_\_\_," respectively. References to other documents in the record include the judgment ("J. \_\_\_\_"), appellants' brief ("Br. \_\_\_\_"), the transcript of the trial below ("Tr. \_\_\_\_"), the transcript of the preliminary injunction hearing ("HTr. \_\_\_\_"), the exhibits introduced by the Commission at that hearing ("PX \_\_\_\_"), the exhibits introduced at trial by the Commission ("PTX \_\_\_\_"), and the Commission's complaint ("C. \_\_\_\_"). References to the Appendix are denoted as ("App. \_\_\_\_").
- 2/ Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Sections 10(b) and 15(c) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and 78o(c)(2), and Commission Rules 10b-5, 10b-6 and 15c2-4, promulgated under the latter act, 17 C.F.R. 240.10b-5, 240.10b-6, 240.15c2-4, 240.17a-3 and 240.17a-4 (J. 2-4; App. 469a-472a).  
The court also enjoined appellants Commonwealth, Drucker, Kleinman, Sharpe, and one other defendant from violating the bookkeeping requirements of Section 17(a) of the Securities Exchange Act, 15 U.S.C. 78q(a), and Rule 17a-3, 17 C.F.R. 240.17a-3 (J. 4; App. 472a).
- 3/ Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated under the latter Act (J. 2; App. 469a-470a).

an investment company. 4/ With the exception of DK&B Management Inc. ("DK&B"), 5/ the appellants (and one other defendant) were directed, in addition (J. 8; App. 475a), to disgorge a total of \$405,541.25. This sum represented the profits they were found to have realized by engaging in certain transactions in securities of Beneficial Labs Inc. ("Beneficial") that violated requirements of the federal securities laws.

The Commission commenced this action on May 8, 1974, after an investigation had disclosed that Messrs. Drucker and Kleinman (a) had conducted a closing of a public offering of Beneficial securities, in which appellant Commonwealth Chemical Securities Inc. ("Commonwealth") 6/ had served as underwriter, at a time when the minimum number of securities necessary for a closing under the terms of the offering had not been sold; (b) had manipulated the trading in Beneficial securities after the closing; and (c) had orchestrated sales of large blocks of Beneficial securities, at artificially inflated prices, to the New York Hedge Fund, Inc. ("Hedge Fund") and to the Vanguard Fund, Inc. ("Vanguard Fund"), two publicly-held investment

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4/ Sections 17(a), 36(a), 37 and 48(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(a), 80a-35(a), 80a-36 and 80a-47(a); Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6 (J. 5-7; App. 472a-475a).

5/ DK&B was registered with the Commission pursuant to Section 203 of the Investment Advisers Act, 15 U.S.C. 80b-3.

6/ Commonwealth was registered with the Commission as a broker-dealer in securities pursuant to Section 15(b) of the Securities Exchange Act, 15 U.S.C. 78o(b).

companies that were also controlled by appellants Drucker and Kleinman. 7/ On the basis of this conduct, the Commission's complaint (C. 1-36; App. 9a-48a) alleged that fifteen defendants had violated provisions of the federal securities laws. 8/

The Individual Appellants

As indicated above, the two corporate appellants are Commonwealth, which during the time of the transactions involved was registered as a broker and dealer in securities, and DK&B, which was registered as an investment adviser.

Appellant Robert C. Drucker was (a) vice-president, director and 25 percent shareholder of appellant Commonwealth, (b) the president, chairman of the board and a principal shareholder of Federated Equities

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7/ The decisions to purchase the Beneficial securities were ostensibly made by appellant DK&B as investment adviser to the Hedge Fund and the Vanguard Fund.

Although the Hedge Fund was also known as the Berkeley Dean Special Fund at times relevant to this action, the investment company is referred to as the "Hedge Fund" throughout this brief.

8/ The fifteen defendants named in the Commission's complaint included seven defendants who have consented to the entry of permanent injunctions: (a) Beneficial; (b) John Feldman, the president of Beneficial; (c) Cabot Shaw, Inc., a registered broker-dealer; (d) Darold Shirwo, the president of Cabot Shaw; (e) Gerald Wolff, a trader at Cabot Shaw; (f) Vincent Caccese, a trader at A. C. Kluger & Co., Inc., a registered broker-dealer; and (g) Michael Rekoon, a trader at Amherst Securities Corp., also a registered broker-dealer.

Defendant Zoltan Guttman was enjoined from violating certain provisions of the securities laws by the judgment of which review is sought (J. 2, 4; App. 469a-470a, 472a), but voluntarily withdrew his appeal of the judgment on August 1, 1977. In addition, the district court dismissed the action with respect to defendant Dorothy Drucker.

Corp., a holding company that owned approximately 50 percent of the stock of Commonwealth, and (c) a president and director of appellant DK&B (Tr. 270, 272; PTX 12 6, 8, 13; App. 241a, 243a, 357a, 359a, 367a). He also served as president and a director of both the Hedge Fund and the Vanguard Fund (Tr. 115-116; App. 164a-165a). In addition, he is the brother-in-law of defendant John Feldman, who is the president, treasurer and principal shareholder of Beneficial (PX 3 10, 13; App. 70a, 73a).

Appellant Julius Kleinman was president, treasurer, chairman of the board and a 25 percent shareholder of defendant Commonwealth. He was also a vice-president, secretary and director of appellant DK&B (Tr. 270; PTX 12 6, 8; App. 241a, 357a, 367a) and an officer and director of both the Hedge Fund and the Vanguard Fund (Tr. 115-116; App. 164a-165a).

The two remaining individual appellants are Mary C. Sharpe, who served as Commonwealth's bookkeeper (Op. I 4; Tr. 224; App. 195a, 405a), and Marlane Kleinman, also known as Marcia Klein, who is the wife of appellant Julius Kleinman (Op. I 5; App. 406a). The district court found that each of these appellants had either violated the requirements of the federal securities laws or had aided and abetted certain violative conduct on the part of Messrs. Drucker and Kleinman.

The Fraudulent Closing of the Beneficial Offering

On December 20, 1971, appellant Commonwealth commenced a "best efforts 50,000 units or none" public offering, pursuant to Regulation A, 9/ of 100,000 units of Beneficial securities (Op. I 3, 6-7; PX 3 1, 12; App. 404a, 407-408a, 61a, 72a). Each unit was offered to the public at a price of \$2.25 and

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9/ Regulation A, 17 C.F.R. 230.251-230.263, provides a conditional exemption from the registration requirements of Section 5 of the Securities Act, supra, for small issues of securities.

consisted of one share of common stock and one warrant that was immediately exercisable for the purchase of another share of common stock at \$2.25 per share (Op. I 6; PX 3 1, 12; App. 407a, 61a, 72a).

The offering circular distributed to the public by Commonwealth represented that Commonwealth would use its "best efforts" to sell 100,000 units of Beneficial securities (PX 3 1, 12; App. 61a; 72a); that the first 50,000 units would be sold on an "all or none" basis (PX 3 1, 12; App. 61a, 72a); that "all funds received from subscribers [to the offering would] \* \* \* be placed in a special bank account" (PX 3 12; App. 72a); and that, unless the minimum of 50,000 units were sold by March 19, 1972, "all funds [received] from subscribers \* \* \* [would] be refunded in full without interest." (PX 3 1; App. 61a). 10/ According to the terms of the offering circular (PX 3 1; App. 61a), the minimum portion of the offering was to generate aggregate proceeds of \$112,500, of which Beneficial would receive \$92,750 and Commonwealth would receive \$19,750 for its commission and expenses.

On December 13, 1971, Alexander Bienenstock, the Chief Attorney of the Branch of Small Issues of the Commission's New York Regional Office, held

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10/ In this regard, Commission Rule 15c2-4, 17 C.F.R. 240.15c2-4, makes it a "fraudulent, deceptive or manipulative act or practice," inter alia, for any broker or dealer participating in an offering of securities "on an 'all-or-none' basis, or on any other basis which contemplates that payment is not to be made to the \* \* \* [issuer] until some further event or contingency occurs \* \* \*," to accept any part of the sale price of the securities unless (a) it should promptly deposit all funds received from subscribers "in a separate bank account, as agent or trustee for the \* \* \* [subscribers] until the appropriate event or contingency has occurred \* \* \*"; and (b) "the funds are [thereupon] promptly transmitted or returned to the persons entitled thereto \* \* \*." See also Rule 10b-9, 17 C.F.R. 240.10b-9. A "best efforts" underwriting, in contrast to a "firm commitment" underwriting, does not require the underwriter to commit any capital to the offering and thus permits the underwriter to avoid the danger of loss on any unsold portion of the distribution. See Securities and Exchange Commission, Special Study of Securities Markets, H. Doc. 95, pt. 1, 88th Cong., 1st Sess. (1963) 494-495 [sometimes referred to herein as the Special Study Report].

a "due diligence conference" with representatives of Commonwealth and Beneficial to advise them "how the offering should proceed \* \* \*" (Tr. 84, 87A-88, 92; App. 153a-155a, 157a). The purpose of the conference "was to inform the persons involved \* \* \* of their duties and obligations \* \* \* "in connection with the offering (Op. I 7; see Tr. 88; App. 408a, 155a).

The "due diligence" conference was attended by appellant Julius Kleinman, the president of Commonwealth, by John Feldman, the president of Beneficial, and by two attorneys representing Commonwealth and Beneficial (Op. I 7; Tr. 92; App. 408a, 157a). Mr. Bienenstock informed them "that funds representing 50,000 units [of Beneficial securities] would have to be in the bank within 90 days from the date \* \* \*" the offering commenced, and that, if sufficient funds were not deposited in the special bank account by that date, all of the funds received from investors "would have to be returned to subscribers in full" (Tr. 94; Op. I 7-8; App. 159a, 403a-409a). 11/ Mr. Bienenstock also stated that, if the minimum number of units were sold prior to March 19, 1972, a closing should be held immediately, and that further closings, if any, should take place weekly until the termination date of the offering. (Op. I 7-8; Tr. 96; App. 408a-409a, 161a).

The district court found, after a four-day trial, that Commonwealth was not able to sell the minimum number of Beneficial units necessary to conduct a closing under the terms of the offering (Op. I 11, 34; App. 412a, 435a)

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11/ Mr. Bienenstock testified that, in due diligence conferences such as the one involved in the instant case, he stresses the requirement "that the minimum funds, in other words, the gross amount that should be received from the minimum number of shares as set forth in the offering circular, must be in the special account \* \* \* by the termination date of the offering \* \* \*" and that, "[i]n the event \* \* \* such minimum amount is not in the bank by that date, all funds received from subscribers must be returned" (emphasis added) (Tr. 89; App. 156a).

and that the special bank account "never contained more than \$94,033.75," approximately \$18,500 less than the sum that should have been deposited in the account if the minimum number of units had actually been sold (Op. I 9; see PX 4; Tr. 325; App. 410a, 77a, 296a). Nevertheless, despite the failure to sell the required minimum of 50,000 Beneficial units, Commonwealth amended the offering circular, on March 8, 1972, to reflect that "50,650 units had been sold and paid for [as of that date] and \* \* \* [that Beneficial had] received net proceeds of \$94,033.75" (Op. I 8; PX 3 1; App. 409a, 60a).

On the same date, Mr. Kleinman wrote a letter to the Commission (PX 6; App. 78a-79a) representing that Commonwealth had subscribers for 50,650 units, stating that he expected a closing to be held within a few days, and transmitting a list of the subscribers to the offering that showed the number of units each subscriber had allegedly agreed to purchase. 12/ Thereafter, on March 10, 1972, contrary to "the plain representation of the offering circular" (Op. I 9; App. 410a), and despite Mr. Bienenstock's specific instructions concerning the conduct of the offering, Commonwealth, in defiance of the requirements of Rule 15c2-4, conducted a closing of the offering and delivered \$94,033.75 to Beneficial in exchange for certificates representing 50,650 units of that company's securities (Op. I 8, 16, 34; App. 409a, 417a, 435a).

In addition to finding that the minimum number of Beneficial units had not been sold, the district court determined (Op. I 9-15, 34-35; App. 410a-416a, 435a-436a) that appellants Drucker, Julius Kleinman, Sharpe and Commonwealth had participated in a scheme "to camouflage the failure" of

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12/ PX 6 erroneously lists Sherry Ashen as Sherry Ash & Co.

the offering by placing 10,000 units, or 20 percent of the required minimum, in six nominee accounts. The court found (id.) that these transactions, including Commonwealth's alleged sale of 8,000 units to a Mr. Massad through four nominee accounts, and its repurchase of the same units "two or three weeks" later (see Tr. 317-318; App. 288a-289a), were not bona fide subscriptions to the offering. On this basis, the court declared (Op. I 11; App. 412a) "that Commonwealth, contrary to the representations made in the offering circular, as amended, and in [Julius] Kleinman's letter to the SEC, had not sold 50,650 units by March 8, 1972; nor had it received and deposited the sales price for such units." It held, accordingly (Op. I 34-35; App. 435a-436a), that Messrs. Drucker, Kleinman and Commonwealth violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and, implicitly, Rule 10b-5 promulgated under the latter Act. 13/ The court below also found (Op. I 35-36; App. 436a-437a) that Messrs. Drucker and Kleinman, and Commonwealth, had violated Section 15(c)(2) of the Securities and Exchange Act and Rule 15c2-4 promulgated thereunder (supra, n. 10) by causing "a fraudulent closing to be held", rather than returning

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13/ Although the court did not expressly find that Messrs. Drucker and Kleinman, and Commonwealth, violated Rule 10b-5 in connection with the offering, it did find that appellant Sharpe and defendant Guttman "knowingly" aided and abetted Drucker's and Kleinman's violations of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated under the latter Act by each purchasing 1,000 of the Beneficial units offered through nominee accounts that they controlled (Op. I 11-15, 45-46; App. 412a-416a, 446a-447a). The court also found (Op. I 11-12; App. 412a-413a) that these transactions were effected to help "camouflage the failure of the Beneficial offering" and stated (Op. I 45-46; App. 446a-447a) that

"these defendants, as insiders of Commonwealth, were in a position to realize that their actions would further the illegal activities of Drucker and Kleinman and, in the exercise of reasonable care, should have concluded \* \* \* that their acts would be used to further the scheme to defraud."

"the subscribers' funds, as they should have," when they failed to obtain subscriptions for the required minimum of 50,000 units. 14/

Manipulation

The district court found (Op. I 40; See Op. I 17-29; App. 441a, 418a-430a) that, "[i]mmediately subsequent to the closing" on March 10, 1972, "Commonwealth, Drucker and [Julius] Kleinman commenced trading in Beneficial securities in a manner calculated to inflate their price artificially" and thereby violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated under the latter act. In this regard, the court held (Op. I 18-19, 40,42; App. 419a-420a, 441a, 443a) that these appellants had manipulated the market in Beneficial securities by dominating the trading of such securities through twelve "accounts under their direct control", 15/ by engaging in "prearranged swap transactions", and by selling "substantial blocks of these securities to the Hedge and Vanguard Funds \* \* \*" at artificially inflated prices.

In finding that Commonwealth, and Messrs. Drucker and Kleinman had dominated the trading of Beneficial securities, the district court relied

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14/ In addition, the court found (Op. I 39; App. 440a) that Commonwealth, aided and abetted by Messrs. Drucker and Kleinman, appellant Sharpe and defendant Guttman, violated Section 17(a) of the Securities Exchange Act and Rule 17a-3 promulgated thereunder "in that its records did not reflect the beneficial owners \* \* \*" of the nominee accounts used to camouflage the failure of the Beneficial offering. It also found (Op. I 36-37; App. 437a-438a) that Commonwealth and Messrs. Drucker and Kleinman violated Section 10(b) of the Securities Exchange Act and Rule 10b-6 promulgated thereunder by "trading in Beneficial securities \* \* \*" at a time when Commonwealth "had not 'completed' its participation in the offering \* \* \*." The court did not find, however, that these appellants had violated Section 5 of the Securities Act, as the Commission had alleged in its complaint. (Op. I 37-39; App. 438a-440a).

15/ The twelve accounts are listed at Op. I 18-19; App. 419a-420a.

(Op. I 19-20; App. 420a-421a) on three charts prepared by Mr. Jerold Judkowitz, a member of the Commission's staff. Based on its examination of the first chart 'PX 7; App. 80a), the court found (Op. I 19-20; App. 420a-421a) that the twelve accounts controlled by Messrs. Drucker and Kleinman, and Commonwealth and DK&B "participated in about 70% of all transactions in Beneficial common stock from March 10, 1972, to February 23, 1973, 41% on the buying side." 16/ The court also found (Op. I 20, see PX 7; App. 421a, 80a) that, [i]n "9% of all these transactions, controlled accounts were on both the buying and the selling sides." In addition, the court held (Op. I 19-20, see PX 9 and PX 10; App. 420a-421a, 89a and 93a) that, between March 10, 1972, and February 15, 1973, the twelve controlled accounts "participated in about 67% of all transactions in Beneficial warrants \* \* \*" and that during the period between March 10, 1972, through January 10, 1973, those accounts participated in "51% of all transactions in Beneficial units \* \* \*," consisting of one share of common stock and one warrant.

The court found that these appellants' dominance of trading in Beneficial securities is "even more significant \* \* \* [in view of] the rapid increase in the price \* \* \*" of those securities during the six month period following the closing, a period during which "no earnings were reported by Beneficial" (Op. I 21; App. 422a). The court determined, in this regard, that the price of Beneficial common stock (which, until March 10, 1972, had been offered with warrants at \$2-1/4) rose sharply after the closing to \$4 bid - \$5 offer on March 14, 1972, and to \$14 bid - \$15 offer by the end of September 1972 (Op. I 21; App. 422a). Similar increases occurred in the prices of the warrants and of the units consisting of stock and warrants (Op. 21, see PX 9 and PX 10; App. 422a, 89a and 93a). The record reflects

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16/ Op. I 20; App. 421a. The record reflects, in addition, that the twelve controlled accounts were on both the buying and the selling sides in a number of the transactions in Beneficial warrants and Beneficial units (see PX 9 and PX 10; App. 89a, 93a).

that the price of Beneficial common stock continued to rise thereafter to a high of \$24 1/2 on January 15, 1973 (PX 7; App. 85a).

The district court found further evidence of manipulation in the fact that appellants Drucker and Commonwealth used Amherst Securities, another broker-dealer, as an intermediary to sell "7,000 shares of Beneficial common stock from the account of Lori Rukasin, which defendant Drucker controlled, to the Vanguard Fund, of which he was an officer and investment adviser" (Op. I 22-23, see Tr. 62, 64-66, and 310-311; App. 423a-424a, 138a, 140a-142a, 281a-282a). 17/ This transaction was effected on August 7, 1972, at a price of \$7 1/8 per share (see PX 7, Tr. 116-117, 312-315; App. 83a, 165a-166a, 283a-286a). The proceeds of the sale, approximately \$49,000.00, were deposited in Commonwealth's bank account (Tr. 312-315; App. 283a-286a).

The court also found that, a short time later, appellant Drucker made arrangements for Commonwealth to sell 8,000 shares of Beneficial common stock to the Hedge Fund, using A. C. Kluger, a different broker-dealer, as a go-between to effect that transaction (Op. I 22, see Tr. 19-20, 23; App. 423a, 109a-110a, 111a). In this regard, defendant Vincent Caccasse, a former trader for A. C. Kluger testified (Tr. 19-20, 23; App. 109a-110a, 111a) that appellant Drucker called him on September 19, 1972; requested that he "open up an account" for the Hedge Fund; and asked him "to go into the street to purchase 8,000 shares of Beneficial \* \* \*" common stock for the account. Mr. Caccasse stated that he then contacted several "other market makers" and learned that there "was no [Beneficial] stock available" (Tr. 24; App. 112a). 18/ When he "went back to . . . Robert Drucker and told him \* \* \*" that he could not obtain any Beneficial stock, appellant Drucker suggested that he check with Commonwealth "and see if they

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17/ Lori Rukasin is defendant Drucker's sister-in-law (Tr. 5; App. 99a).

18/ At that time, there were only "five or six" marketmakers in Beneficial securities (Tr. 336; App. 307a).

have the stock" (Tr. 24-25; App. 112a-113a). According to the trader, he then "called up" Commonwealth, and learned that "they had 8,000 shares of Beneficial \* \* \* for sale, \* \* \* bought the stock from them" and then sold the shares to the Hedge Fund as appellant Drucker had ordered (Tr. 25; App. 113a). Mr. Caccasse testified that he called appellant Drucker to report "that the order was executed", but that Mr. Drucker "laughed when I told him \* \* \*" (Tr. 26; App. 114a). Mr. Drucker later informed Mr. Caccasse that Commonwealth did not sell the shares "directly to the funds \* \* \* [because] it was my impression based on discussions that I had with counsel that the fund could not buy directly from Commonwealth and had to buy from a marketmaker" (Tr. 330-331; App. 301a-302a). 19/ The district court noted in this regard (Op. I 22; App. 423a)

"that Drucker was manipulating the market is clear from the indisputable fact that behind the scenes he was on both sides of the transaction, dealing with himself in his dual and conflicting roles as a director and investment adviser of the \* \* \* [Hedge Fund] and as president of the seller, Commonwealth."

The court found another example of a manipulative transaction in "a dollar for dollar exchange of stock," on February 15, 1973, between Commonwealth and a third broker-dealer firm, defendant Cabot Shaw, Inc. (Op. I 23-24; App. 424a-425a). Pursuant to this exchange, Cabot Shaw purchased 2,000 Beneficial units from Commonwealth at a price of \$35 per unit, or a total of \$70,000; in return, Commonwealth purchased 4,500 shares of common stock of Environmental Devices, Inc. ("EDI") from Cabot Shaw at a price of \$7-3/4 per share,

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19/ This response was elicited after appellant Drucker had been asked whether he had informed the trader "that there was a rule which prohibited \* \* \* [him] from transacting this trade \* \* \* at Commonwealth \* \* \*" (Tr. 330-331; App. 301a-302a).

or \$34,875, and Jacob Arner, the uncle of Mr. Kleinman, purchased an additional 5,000 shares of the stock from Cabot Shaw at the same per share price, amounting to \$38,750 (id.). The record reflects (Tr. 47, 348, PX 10; App. 128a, 348a, 93a) that the prices paid by each party were based on the prevailing "bid" prices for the two securities. The court below declared in this context (Op. I 25; App. 426a):

"This type of transaction introduces a foreign element—a prearranged business quid pro quo—to those which normally establish the price of a particular stock, namely, supply and demand in a public auction market, free from artificial manipulation, and the performance of the issuing company in a system of free competitive enterprise. Such a transaction is manipulative both because it tends to support an artificial and inflated price for the securities and because it portrays a false appearance of wide investor interest." 20/

#### C. Violations With Respect to the Fund Transactions

Messrs. Drucker and Kleinman, who were officers and directors of Commonwealth, were also, as we have seen, officers and directors of the Vanguard Fund and the Hedge Fund and, through DK&B, served as investment advisers to each of the funds. The district court found, in this regard (Op. I 30; App. 431a), that Messrs. Drucker and Kleinman "took advantage of their dual and conflicting roles by causing the funds to buy, and Commonwealth to

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20/ The district court also found that appellants Sharpe and Marlane Kleinman participated in a number of transactions that "coincided with the manipulations of Messrs. Drucker and Kleinman," and declared that "there is no blinking the fact that each of these defendants was inextricably linked to those dominant insiders \* \* \*" (Op. I 27; App. 428a). The court concluded (Op. I 29; App. 430a) that these appellants "were in a position to know of the illegal scheme [to manipulate the market in Beneficial securities], saw an opportunity to make substantial profits, participated in the trading, and negligently, if not knowingly, aided the manipulation." Accordingly, it held that appellants Sharpe and Marlane Kleinman had each violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated under the latter Act (Op. I 44-46; App. 445a-447a).

unload, large amounts of Beneficial securities at artificially inflated prices." These transactions, including the two discussed in the previous section, resulted in the purchase of a total of 22,100 shares of Beneficial common stock by the two funds, "at a cost of \$177,012.50, and 3,000 Beneficial warrants, at a cost of \$43,125" (Op. I 30; App. 431a). The court determined that this "callous disregard of fiduciary duties, brazen conflict of interest and fraudulent self-dealing [of Messrs. Drucker and Kleinman] thus mulcted the funds of \$220,137.50," (*id.*). 21/

The court found that another instance "of fraudulent dealing by these fiduciaries" occurred in late February, 1973, when appellant Drucker "asked Cabot Shaw to buy 5,000 shares of EDI from Commonwealth and to sell them to the Vanguard Fund" (Op. I 30, Tr. 39-40; App. 431a, 120a-121a). Mr. Wolff, a trader at Cabot Shaw, "questioned Drucker's authority to buy for the fund \* \* \*" and Mr. Drucker asserted: (a) that "he did" have such authority; and (b) that he would have a member of the Vanguard Fund call \* \* \* [Mr. Wolff] and confirm the transaction (Op. I 30, Tr. 40; App. 431a, 121a). "Approximately fifteen minutes later," Mr. Kleinman called the trader and asked him to deliver the 5,000 shares of EDI to the Vanguard Fund (*id.*). Cabot Shaw thereupon purchased "the shares from Commonwealth at \$7-5/8 per share, and sold them to [the] Vanguard [Fund] at \$7-3/4 per share" (Op. I 31, see Tr. 40; App. 432a, 121a). The court declared that this "calculated self-dealing by Drucker and Kleinman demonstrates their blatant breach of their fiduciary obligations to deal

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21/ Although the Funds were able to recover a portion of their investment by selling their holdings of Beneficial securities at a later date, the court determined that they "sustained an aggregate net loss of \$158,345" (Op. I 33; App. 434a). Of this total, the Vanguard Fund suffered a net loss of \$66,325, while the Hedge Fund sustained a net loss of \$92,020 (Op. I 33 n. 10; App. 434a n. 10).

faithfully for the benefit of the shareholders of the funds" (Op. I 31; App. 432a).

Messrs. Drucker and Kleinman had recruited a Dr. Smith and a Dr. Dash to serve as independent directors of both the Hedge Fund and the Vanguard Fund, but these individuals were not aware that the funds had been acquiring large blocks of Beneficial securities until they were informed of the acquisitions by Mr. Drucker at a directors' meeting in December 1972 (Tr. 113-117; App. 162a-166a). 22/ They were surprised to learn that the Hedge Fund had invested more than 60 percent of its assets in Beneficial securities and that the Vanguard Fund had invested 20 percent of its assets in such securities (Tr. 117; App. 166a). Dr. Smith said that Mr. Drucker told him, in this regard, that the funds had acquired the securities "between August and October of \* \* \* [1972] at approximately \$7 or \$8 a share [and] that \* \* \* the price was \$24 a share" at the time of the meeting (id.). According to Dr. Smith, Mr. Drucker stated (Tr. 118; App. 167a), that the funds had acquired "more [Beneficial securities] than we were allowed to have according to the policy of the funds \* \* \*, that Mr. Feldman, "the president of Beneficial \* \* \* had more than half \* \* \* the outstanding shares and that the float was very thin." According to Dr. Smith, Mr. Drucker said, "If we decided to sell an appreciable block [of Beneficial securities] it would bring the price right down" (id.).

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22/ Dr. Smith testified that Mr. Kleinman had (a) asked him to become a director; and (b) "told me that \* \* \* most of the duties would be taken [care of] by Mr. Drucker and Mr. Kleinman and that, in effect, my being on the board of directors was \* \* \* a formality and a requirement of the SEC \* \* \*" (Tr. 114-115; App. 163a-164a).

A short time later, in the third week of February, 1973, appellant Drucker asked Cabot Shaw if that firm "could buy 3,000 shares of Beneficial \*\*\* common at 11-1/2 from the \*\*\* Hedge Fund, and [stated] that he would try to find a home for it later on" (Tr. 36-37, 291-294; App. 117a-118a, 262a-265a). 23/ Cabot Shaw subsequently "bought 3,000 shares of Beneficial common at 11-1/2 from the \*\*\* Hedge Fund and sold it at 11-3/8 approximately a day later to Commonwealth \*\*\*," ostensibly "on an agency basis" for Mr. Kleinman's uncle, Joseph Arner (Tr. 38, 294, 350; App. 119a, 265a, 321a).

The Commission suspended the trading of Beneficial securities on March 5, 1973, and issued consecutive ten-day suspension orders that continued the trading suspension through October 30, 1973 (Op. I 32, PTX 12 3; App. 433a, 352a). As of March 2, 1973, the last trading date before the trading suspension commenced, Beneficial common stock and warrants comprised approximately 71 percent of the total net asset value of the Hedge Fund (Op. I 32; PTX 12 3; App. 433a, 352a). On the same date, approximately 17.7% of the net asset value of the Vanguard Fund was attributable to its holdings of Beneficial securities (Op. I 32; PTX 12 4; App. 433a, 352a).

The district court noted (Op. I 32; App. 433a) that it was subsequently decided "that the Hedge Fund should be liquidated \*\*\*" and that the Vanguard Fund should transfer its assets to the Pilgrim Fund, Inc.,

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23/ The price of the common stock reflects the fact that Beneficial declared a stock dividend of 100 percent in February, 1973 (see PTX 12; App. 352a).

When Mr. Drucker was asked why he did not purchase the stock himself, he explained that "he would be breaking a rule \*\*\*" if he did so (Tr. 37; App. 118a).

another investment company, in exchange for shares of that Fund. As part of the latter transaction, the Pilgrim Fund shares were to be distributed to former shareholders of the Vanguard Fund in a tax-free reorganization (Op. I 32; App. 433a). 24/

The district court found, after reviewing the record in this case, that the Commission had made a "clear showing" that Messrs. Drucker, and Kleinman and Commonwealth had "acted purposefully in their dual and conflicting roles in placing large blocks of Beneficial securities with the funds at the same time they were artificially inflating the price of the securities \* \* \*" (Op. I 42; App. 443a) thereby "'dumping' large blocks of \* \* \* watered securities on the funds \* \* \*" (Op. I 43; App. 444a). The court determined, on this basis, that these appellants, together with appellant DK&B, had violated Sections 17(a), 36(a), 37, and 48 of the Investment Company Act. 25/ In addition, the court held that DK&B, aided and abetted by Messrs. Drucker and Kleinman, had violated Section 206 of the Investment Advisers Act (Op. I 44; App. 445a).

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24/ The proxy materials concerning the proposed liquidation of the Hedge Fund reflect that it had 53,295 shares of capital stock outstanding as of May 22, 1974 (PTX 12 1; App. 352a). The proxy materials distributed with respect to the Vanguard Fund indicate that it had 351,590 shares outstanding as of May 3, 1974, and that these shares were held of record by 1,700 stockholders (id.).

25/ The court did not consider, however, the Commission's allegation that the defendants had also violated Section 17(d) of the Investment Company Act and Rule 17d-1 promulgated thereunder (see Op. I 41 n. 17; App. 442a n. 17).

ARGUMENT

I. THE FINDINGS OF THE DISTRICT COURT ARE FULLY SUPPORTED BY THE EVIDENCE AND ARE NOT CLEARLY ERRONEOUS.

The facts set forth above, amplified by the discussion that follows, show that the district court's findings are fully supported by the evidence.

Rule 52(a) of the Federal Rules of Civil Procedure provides that, in actions tried without a jury, "[f]indings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witness." Thus, the question for this Court "is not whether it would have made the findings the trial court did," Zenith Corp. v. Hazeltine, 395 U.S. 100, 123 (1969). For where the evidence would support two different conclusions, a choice by the trial court between two permissible views is not clearly erroneous.

United States v. Yellow Cab Co., 338 U.S. 338, 342 (1949); Ferguson v. Post, 243 F. 2d 144, 145 (C.A. 2, 1957). And where, as here, the findings made by the court below "relate to the design, motive and intent behind human actions," the court of appeals, "equipped only with a 'cold' record, is appropriately reluctant to reject the credibility evaluation of the district court." Palermo v. Warden, Green Haven State Prison, 545 F. 2d 286, 293 (C.A. 2, 1976); see also United States v. Yellow Cab Co., supra, 338 U.S. at 341; Caputo v. Henderson, 541 F. 2d 979, 984 (C.A. 2, 1976); Carrion v. Yeshiva University, 535 F. 2d 722, 728 (C.A. 2, 1976).

A. The district court properly determined that the appellants violated or aided and abetted violations of provisions of the federal securities laws by participating in a scheme to conduct a fraudulent closing of the Beneficial offering.

As noted above (pp. 11-13), the district court found that Messrs. Drucker and Kleinman caused a closing of the Beneficial public offering to be held at a time when the minimum number of units required to conduct

the closing had not been sold; and that the special bank account established for the deposit of subscribers' funds never had deposits amounting to \$112,500, the sum that should have been deposited if the required minimum 50,000 Beneficial units actually had been sold.

The special bank account had deposits of only \$94,033.75 (Op. I 8-9; PX 4; App. 409a-410a, 77a). This fact alone, the district judge pointed out, was a strong indication that the appellants had sold insufficient units to be able to conduct a closing (Op. I 9, 16-17; App. 410a; 417-418a).

Appellants claim, however (Br. 11), that "Commonwealth had collected the required amount to close, \$94,033.75, being the net proceeds for the sale of 50,650 units, [that] \* \* \* it transmitted those funds to Beneficial \* \* \* retaining its own commission," and that these facts constitute "evidence" that Commonwealth sold "more than the minimum number of units \* \* \*." The offering circular distributed to the public in connection with the offering expressly represented, however (PX 3 12, Op. I 6-7, 16; App. 60a, 407a-408a, 417a): "All funds received from subscribers will be placed in a special bank account, to be maintained for the benefit of subscribers, until such time as subscriptions for at least 50,000 \* \* \* [units] have been received" (emphasis added) and that, unless the minimum of 50,000 units should be sold by March 19, 1972, all funds received from subscribers "shall be promptly refunded in full without interest." It did not represent that "the underwriter would first deduct commissions and then deposit only the remainder" (Op. I 16; App. 417a). In addition, defendant Commonwealth had been informed, at the due diligence conference attended by defendant Kleinman (Tr. 92, 94; App. 157a, 159a), that the gross amount received from subscribers for 50,000 Beneficial units "would

have to be in the bank within 90 days from the date \* \* \* " the offering commenced in order to conduct a closing. Moreover, Rule 15c2-4, supra, n. 10, clearly required that all investor funds be deposited in the special account and kept there until the minimum number of units had been sold. The record reflects, however (Op. I 9; PX 4; App. 410a, 77a), that "the special account [established for the deposit of subscribers' funds] never contained more than \$94,033.75 at any time prior to the closing" (emphasis added). 26/ Accordingly, the court below properly rejected the defendants' contention that the transmittal of the net proceeds of the offering to Beneficial is evidence that more than 50,000 units had been sold (Op. I 16-17; App. 417a-418a):

"[The] defendants [did not] even attempt to answer the troublesome question of how Commonwealth could take its commissions in good faith before it was entitled to them under the terms of the offering, viz., before the successful closing? Absent participation in a fraudulent engineering of the closing, no one could be prescient enough to know that a particular offering will succeed before that event actually occurs."

After reviewing all of the evidence concerning the closing, the court below declared (Op. I 34-35; App. 435a-436a):

"A subscriber to an offering, made on a 'part or none' representation, is assured that he will be entitled to a full refund of his money if the security fails to appeal to a sufficient number of investors to reach the minimum limit. These defendants, however, knowing that sales to the public were falling short of the required 50,000 unit minimum, disguised the investing public's rejection of the offer by spurious sales to controlled accounts and by closing the issue knowing full well that 50,000 units had not been sold."

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26/ The court below found that the special escrow account should have had deposits totalling \$113,962.50 if 50,650 Beneficial units had in fact been sold (Op. I 9; App. 410a).

The district judge did not rely solely on the fact that the special bank account never contained as much money as it should have. He pointed out that appellants' explanations of the alleged sales of 10,000 of the Beneficial units to six nominee accounts were "incredible" (Op. I 11-13; App. 412a-414a). The appellants claim that a Mr. Massad and two other persons purchased 10,000 Beneficial units in the offering through six nominee accounts (see Br. 11). The district court found, in this regard (Op. I 11; App. 412a), that Mr. Massad "was not a bona fide purchaser, but a mere tool of the defendants for camouflaging the failure of the offering."

The 8,000 Beneficial units allegedly sold to Mr. Massad were ostensibly sold to nominee accounts in the names of Sheila Goldberg, Sherry Ashen, Alice Greenblatt and Mary Boilen (Op. I 10; see PX 6; App. 411a, 78a). These names had been given to appellant Drucker, at his request, by an employee of Commonwealth named Joanne Reichin (Op. I 10; Tr. 56-58; App. 411a, 135a-137a). Appellant Drucker testified (Tr. 295-296, 316; App. 266a-267a, 287a), in this context, that Mr. Massad contacted him after hearing "of the [Beneficial] issue through a mutual friend," that Mr. Massad said "he wanted to buy a certain number of units," but "did not want \* \* \* [the purchase] to appear in his own name" and that he (Drucker) agreed to assist Mr. Massad "in finding people who would not mind being nominees for his account \* \* \*." He testified further (Tr. 296; App. 267a) that he then asked Joanne Reichin if she had "any girlfriends who would mind being [a] nominee for a customer who wants to buy the stock and \* \* \* doesn't want to put it in his own name." 27/ She subsequently advised him (id.) that she had four friends

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27/ Mr. Drucker did not explain why more than one nominee was sought on behalf of Mr. Massad.

who "would have no objection as long as it didn't cost them any money \* \* \*." At this point, appellant Drucker opened accounts at Commonwealth in the name of each woman and placed 2,000 Beneficial units in each account. 28/

This "explanation" would be suspect even if there were no other evidence that the alleged sale of 8,000 Beneficial units to Mr. Massad was not a bona fide transaction, but the story becomes even less credible in view of defendant Drucker's admission (Tr. 317-318; see Op. I 11; App. 288a-289a, 412a) that he bought the 8,000 Beneficial units back from Mr. Massad just "[t]wo or three weeks after the closing \* \* \*." 29/ In addition, the defendants did not call Mr. Massad at the trial in an attempt to corroborate appellant Drucker's testimony (Op. I 11; App. 412a). These circumstances fully support the district judge's determination (id.) that appellant "Drucker's testimony on this matter [was] incredible."

The conviction of the district judge that appellant Drucker was not telling the truth was underlined toward the end of the trial, when the district judge commented, in a different context, "I don't believe a word he [Drucker] says \* \* \*" (Tr. 383; App. 351a). 30/

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28/ The list of subscribers sent to the Commission by appellant Julius Kleinman, on March 8, 1972 (PX 6; App. 78a), represented that each of the four women had agreed to purchase 2,000 Beneficial units.

29/ The judge also noted in this regard, (Op. I 10-11; App. 411a-412a) that Mr. Massad failed "to pay for his units before the termination date [of the offering], as other subscribers had done \* \* \*."

30/ The appellants' brief also asserts (Br. 11) that the court below ignored appellant Drucker's testimony "that more than 50,000 units had been sold by March 10, 1972." Even if Mr. Drucker had so testified, the court would have been justified in disregarding that testimony on the ground that it was not credible. The passage cited by defendants in support of this assertion reflects,

(continued)

The district court also found (Op. I 11-12; App. 412a-413a) that appellant Mary Sharpe, by opening an account at Commonwealth in the name of her mother, Nellie Pyles, and purchasing 1,000 Beneficial units in her mother's name before the termination date of the offering, "participated in \* \* \* [the] attempt to camouflage the failure of the Beneficial offering \* \* \*." The court found (Op. I 12; App. 413a) that appellant Sharpe's mother "was completely ignorant of this account and of the transactions allegedly conducted for her benefit," that appellant Sharpe sold 500 Beneficial units "soon after" the closing, that the proceeds of the sale were "deposited \* \* \* in her own bank account \* \* \* [and that the proceeds were] never given to her mother." These findings are fully supported in the record (Tr. 80-82; 225-226; 230-231; App. 150a-152a, 201a-202a; 196a-197a).

Appellant Sharpe attempted to explain her actions by stating that she thought the purchase of the 1,000 Beneficial units "would be a good opportunity for \* \* \* [her] to do something nice for \* \* \*" her mother (Tr. 226; App. 152a) that she intended to give any "profit in the account" to her mother (id.); that she used \$2,250 she had been keeping "at home" to purchase "a money order or cashier's check," which she then used to pay for the purchase (Tr. 243; App. 214a);

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30/ (continued)

however, that Mr. Drucker carefully restricted his testimony to statements that he "believed" Commonwealth had received the proceeds for the required number of shares at the time it held the closing (Tr. 322):

Q. Were all the securities for the minimum 50,000 units paid for as of March 10, 1972?

A. I believe they were.

Q. You believe or do you know?

A. I think - I believe they were.

and that she sold 500 Beneficial units "a few days after \* \* \*" the closing in order to realize a profit of "roughly \$200" (Tr. 230; App. 201a). She added that she kept the proceeds of the sale because of "a disagreement" she had with her mother (Tr. 231; App. 202a), but she was unable to "recall the total circumstances" of the disagreement (Tr. 239; App. 210a). The court below found this "'gift' explanation incredible" and concluded that her mother, Nellie Pyles, "was not a bona fide purchaser" of units in the offering (Op. I 12-13; App. 413a 414a). The court held, on a balance of all the evidence, "including Sharpe's relationship as Commonwealth's bookkeeper, the timing of the transaction, the then significance of 1,000 units to the target quantity, and the spurious explanation given on the [witness] stand, that Sharpe was knowingly attempting to aid and participate in the fraudulent closing of the offering, with some stake in its success \* \* \*" (Op. I 13; App. 414a).

Just as the court below found the testimony of appellants Drucker and Sharpe to be incredible, it also saw no reason why Mr. Kleinman should be believed. While appellants claim (Br. 11) that PX 6 (App. 78a), the letter defendant Kleinman wrote to the Commission on March 8, 1972, and the enclosed list of subscribers to the offering, demonstrate that Commonwealth sold more than 50,000 Beneficial units before the closing, the court below properly determined (Op. I 39; App. 440a) that defendant "Kleinman showed his complicity [in the fraudulent closing] by authoring the March 8, 1972 letter to the SEC containing names of fictitious subscribers." The list of subscribers includes the names of Nellie Pyles, Sylvia Pavel 31/ and the four women who allegedly

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31/ The court found that defendant Zoltan Guttman had also participated in the effort to camouflage the failure of the Beneficial offering by purchasing 1,000 Beneficial units in the name of Sylvia Pavel. (See Op. I 14-15; App. 415a-416a.)

served as nominees for Mr. Massad, persons whom the district court found were not bona fide subscribers to the offering (Op. I 10-15: see PX 6; App. 411a-416a, 78a). These claimed subscriptions account for 10,000 of the 50,650 Beneficial units allegedly sold (see PX 6; App. 78a). The court also pointed out (Op. I 48 n. 26; App. 449a n. 26) that Mr. Kleinman's failure to testify "warrants the inference that the testimony would have been unfavorable," citing, inter alia, this Court's decision in N. Sims Organ & Co. v. Securities and Exchange Commission, 293 F.2d 78, 80-81 (1961), certiorari denied, 368 U.S. 968 (1962).

Appellants contend (Br. 12) that the fact the closing was held ten days earlier than the date the offering had to be terminated "belied" the determination of the court that the required minimum of units had not been sold. But this could have been part of the scheme to disguise the failure of the offering, particularly if it had become apparent that the balance of the 50,000 unit minimum could not be sold before the termination date of the offering (see Op. I. 34-35; App. 435a-436a).

B. The court below correctly found appellants Drucker, Kleinman, Commonwealth and DK&B had manipulated the trading of Beneficial securities after the closing.

The district court found (Op. I 21; App. 422a) that the price of Beneficial common stock rose from the initial offering price of \$ 2.25 (per unit) to a "price of \$4 bid - \$5 offer on March 14, 1972 [four days later] to \$14 bid - \$15 offer by the end of September" of that year. The court also found (id.) that "similar increases [in price] occurred for Beneficial units and warrants." Moreover, although the court below did not make any findings of fact with respect to further price increases, the record reflects that the price of Beneficial stock continued to rise to a high of

\$24 1/2 per share on January 15, 1973 (PX 7; App. 85a). 32/

These dramatic price increases occurred despite circumstances that make the price rises seem inexplicable in the absence of manipulation. These circumstances include the following: (a) Beneficial had "not engaged in any business" prior to commencement of the offering (PX 3, 4; App. 64a); (b) the company proposed to enter a business, "the ownership and operation of pharmacies or \* \* \* [the operation of] drug departments in \* \* \* department stores and supermarkets," in which it would "be subject to intense competition" (id.); (c) its president, "the only full time officer of the company, had had "limited experience in managing drug stores and no experience in operating a business venture" (id.); (d) investors were informed that, although the company could "commence business on a small scale" if only 50,000 units were sold, the failure to sell all 100,000 units offered might severely limit "the potential of the Company" (PX 3, 5; App. 65a); (e) there was "no market for the Company's securities [at the time of the offering] and \* \* \* no assurance that a regular trading market for the shares of Common Stock and Warrants \* \* \* [would] develop \* \* \*" thereafter (id.); and (f) the initial offering price had been "arbitrarily determined" and had "no relationship to the present book value of the Company's outstanding shares or to any established criteria of value" (id.). In addition, the district court

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32/ The price dropped sharply after Beneficial declared a 100 percent stock dividend later that month. The record also reflects (a) that the price of Beneficial warrants rose from a low of \$ 1/4 on March 10, 1972, to \$12 3/4 on October 3, 1972, to a high of \$23 on February 15, 1973 (see PX 9; App. 90a, 92a); and (b) that the price of Beneficial units increased from \$2 3/8 on March 10, 1972, to \$33 on October 5, 1972, to a high of \$36 on November 6, 1972 (see PX 10; App. 94a, 96a).

found (Op. I 21; App. 422a) that "no earnings were reported by Beneficial" between the closing and the end of September, 1972, a period that the price of Beneficial securities rose more than 600 percent (see PX 7; App. 80a). <sup>33/</sup> Under these circumstances, we submit that the district court properly concluded (Op. I 21; App. 422a) that the proposition "is utterly incredible \* \* \* that it was the performance of Beneficial which prompted the dramatic rise in the price of its securities."

The appellants challenge the findings of the court below concerning their participation in manipulative activities by (a) representing that the court declared that the appellants "participated in 51 to 70 percent of the transactions in a particular sample of the transactions in Beneficial securities \* \* \*" (Br. 13); (b) contending that these figures reflect a "point spread" of 19 percentage points in the district court's findings (Br. 16); and (c) characterizing the court's findings as a "very uncertain statistic" (Br. 16). These assertions are highly misleading. In fact, the district court found (Op. I 19-20; App. 420-421), "after careful study" of the evidence, (see PX 7, PX 9 and PX 10; App. 80a, 89a, 93a), that Messrs. Drucker and Kleinman, Commonwealth and DK & B "participated in about 70% of all transactions in Beneficial common stock from March 10, 1972 to February 23, 1973 \* \* \*"; that they "participated in about 67% of all transactions in Beneficial warrants \* \* \*" between the closing and February 15, 1973; and that they "participated in about \* \* \* 51% of all transactions in Beneficial units \* \* \*" between the closing and January 10, 1973 (emphasis added). Appellants' so-called "point spread"

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<sup>33/</sup> Appellant Drucker asserted (Tr. 340; App. 311a) that the prospects for Beneficial looked good "on the horizon" but he did not point out any developments that might have accounted for the sharp increase in the price of Beneficial securities.

(Br. 16) is fabricated by lumping the percentages found for participation in common stock transactions together with the figures for transactions in Beneficial units as if there were no difference in the type of security involved.

The appellants also complain (Br. 13) that the charts used by the court in making the above calculations do not show "all transactions" in Beneficial securities because the Commission "employee who prepared the charts \* \* \* made inquiry of only 20 or so broker dealers." They also assert (Br. 14) that the charts were "prepared from completely unreliable material" by a person "completely lacking in professional training."

Contrary to the appellants' assertion (Br. 14), the Commission employee who prepared the charts is an accountant (Tr. 249; App. 220a). Moreover, appellants' assertion (Br. 14) that the charts entered into evidence by the Commission are not complete is totally without merit. Mr. Judkowitz's testimony indicates that he consulted the "pink sheets" published by the National Quotation Bureau, a private service which publishes daily "the names of broker-dealers making markets in specified securities [also known as 'wholesale dealers'] and their quoted prices." 34/ A wholesale dealer is an "intermediary" who "participates in virtually every transaction originating or terminating with a public buyer or seller \* \* \*." 35/ Using the pink sheets, Mr. Judkowitz was able to locate, out of some "several thousand" broker-dealers (Br. 13), each broker that made a market in Beneficial

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34/ Special Study Report, pt. 2, 552.

35/ Id. at 554.

securities. He then obtained their original order tickets or confirmations in order to prepare the charts and determined what other brokers engaged in trades with these marketmakers. In this manner, he was able to determine the brokers who did have trades in Beneficial securities (H Tr. 61-62, 65-66, Tr. 165-170; App. 53a-54a, 57a-58a, 181a-186a). 36/ The order tickets and confirmations (PX 8; App. 87a), characterized by appellants as "slips of paper" (Br. 15), were the original records of the transactions effected in Beneficial securities. Accordingly, they were properly used in preparing the charts and computations that were made on the basis of PX 7, PX 9, and PX 10. 37/ The district court, therefore, correctly determined (Op. I 20; App. 421a) after "careful study" of the charts, that they "reveal with a reasonable degree of accuracy what they purport to show, that is, trades in Beneficial securities in which the market makers were involved." 38/

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- 36/ As pointed out in the text, *supra*, the Special Study Report states that this would account for "virtually every transaction." Assuming that there were some private sales that did not go through the broker-dealers whose records were examined, this would be unlikely to affect the market found to have been manipulated.
- 37/ The order tickets in Exhibit 8, which appellants claim show that Mr. Drucker sold 3,250 shares rather than 10,000 shares of Beneficial's common stock reflected in the chart, show a sale of 10,000 shares of that stock, but the sellers include, Mr. Kleinman and Ms. Rukasin, a nominee, in addition to Mr. Drucker. For purposes of the manipulation charged against Messrs. Drucker and Kleinman, whether the sale was by one or by both and a nominee could make no difference.
- 38/ Appellants criticize (Br. 14) the "facile manner in which they [the charts] were accepted "into evidence alleging that "[i]n essence the SEC was accorded 'special litigant' status \* \* \*." We submit, however, that the district judge's criticism of Commission counsel (Op. I 2; App. 403a) suggests that he would have accorded them no special favors.

The appellants assert (Br. 16), objecting to the court's finding (Op. I 20; App. 421a) that appellants "participated in about 70% of all transactions in Beneficial common stock from March 10, 1972 to February 23, 1973 \* \* \*," that the "court \* \* \* counted 'transactions [in Beneficial securities] participated in,' rather than 'participants,' with the effect of doubling the percentages \* \* \*" of transactions in Beneficial securities. We submit, however, that the number of transactions that took place in Beneficial securities in which appellants participated on one side or the other or both has relevance to the issue of market manipulation and is a valid gauge of the extent to which appellants controlled the market in Beneficial stock—and the fact that appellants participated in 70% of the stock transactions, as the district court found, shows that the defendants "participated in an extraordinarily large number of transactions involving Beneficial securities" (Op. I 20; App. 421a). Moreover, even if we assume for the purposes of this argument that the defendants had participated in only 35 percent of the transactions in Beneficial common stock, as claimed by appellants (Br. 16), 39/ this still would be a sufficient basis for the finding that they were manipulating the market, particularly where, as the judge found, "controlled accounts were on both the buying and the selling sides in 9% of all the transactions" (id.).

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39/ Appellants' footnote on page 16 of their brief, suggests that under "the district court's method of calculation one could conclude that defendants 'participated in' 110 percent of the transactions," on their assumption "that there were 10 transactions, that one defendant or another was the buyer in 5 transactions, and that some other defendant was the seller in 6 transactions." In that event, we submit that the number of transactions in which defendants would have participated would range anywhere from a minimum of six to a maximum of ten.

The appellants also claim (Br. 16) that the court erred in considering "transactions in which one defendant sold [Beneficial securities] directly to another defendant, without any involvement by the public or other broker-dealers," contending that such transactions "obviously had no impact on the public markets, and could not be relevant to any claim of manipulation." This claim is without merit. Many of these transactions were presumably designed to take large blocks of Beneficial securities out of circulation, or to keep them out of circulation, thus reducing the number of shares available for public trading and permitting a small purchase to exert a strong upward pressure on the price of those securities.

The appellants contend (Br. 19-20), in this regard, that Commonwealth's "dollar for dollar exchange" of 2,000 Beneficial units with Cabot Shaw in return for an equivalent value of EDI securities were "fully open and lawful" transactions, that the transactions "were independent" and that there was no "agreement between Commonwealth and Cabot-Shaw as to the disposition [that would be made] of the securities \* \* \*" exchanged. These assertions ignore the facts that "Messrs. Drucker and Kleinman negotiated and carried out a "dollar-for-dollar" 'swap' of securities" (Op. I 23-24; App. 424a-425a), that, "as part of this transaction \* \* \* [Messrs.] Drucker and Kleinman arranged" for Joseph Arner, the uncle of Julius Kleinman, to purchase 5,000 shares of EDI (Op. I 24, Tr. 41, 48, and 340; App. 425a, 129a, 122a, 311a) and that the effect of the transaction was to take the 2,000 units out of the marketplace, thereby supporting the artificially high price at which the units were trading (see PX 10; App. 93a). They also disregard the fact that the exchange was proposed to Cabot Shaw "to relieve the

pressure on \* \* \*" EDI and was effected "as close to the bid price [of each security] as possible" (Tr. 43-45, 344-345, 348; App. 124a-125a, 319a, 315a-316a). Moreover, Mr. Drucker's desire to take 2,000 Beneficial units out of the marketplace is evident because he knew that the Beneficial units could not be sold to investors in the state of California without complying with that state's blue sky law, and he knew that the requirements of that law had not been met, so that, the 2,000 units "would \* \* \* [have] to stay in the [Cabot Shaw] trading account, unless \* \* \* [Cabot Shaw] found a purchaser outside of the State of California in a state where the stock was blue skied" (Tr. 45; App. 125a). Thus, contrary to appellants' assertion (Br. 20) that the swap "could not have had any effect on the price of Beneficial \* \* \* securities," the "dollar-for-dollar exchange" could have had the "effect [of maintaining] the price of Beneficial \* \* \* securities" at an artificially inflated level and might have had the effect of contributing to a further increase in prices if the Commission had not suspended the trading of Beneficial securities shortly after the transaction was consummated (see Op. I 32; PTX 12 3; App. 433a, 352a).

Moreover, with respect to appellants' claim (Br. 16-17) that the court should have disregarded transactions "in which defendants were sellers rather than buyers," on the premise that selling "exerts downward pressure on price, and \* \* \* is the antithesis of an upward price manipulation," the appellants ignore the fact that the sales of Beneficial securities to the Vanguard Fund and the Hedge Fund had the effect of reducing the number of shares available for public trading. They also disregard the fact that many of these "selling" transactions were matched orders, presumably designed to create the appearance of active trading in Beneficial securities (see PX 7, PX 9 and PX 10; App. 80a, 89a, 93a).

The appellants also contend (Br. 18) that their "participat[ion] in a large percentage of the transactions" in Beneficial securities "more readily connotes maintenance of an orderly market than it does manipulation." Under the circumstances involved in this case, this bald assertion is without merit. Appellants ignore the facts that Messrs. Drucker and Kleinman used twelve controlled accounts to dominate the trading of Beneficial securities during this period, matched purchases and sales, which necessarily gave a false appearance of active trading in the securities, and most significantly, directed the sale of large blocks of Beneficial securities to the two investment companies that they controlled. In August and September of 1972, for example, appellant Drucker orchestrated the sales of 10,350 shares of Beneficial common stock to the Vanguard Fund, of which he was an officer and investment adviser, and an additional 11,600 shares to the Hedge Fund, of which he was also an officer and investment adviser (see PX 7; App. 83a-84a). These transactions had the effect of taking 21,950 shares of Beneficial common stock out of the market (Tr. 118; App. 167a), a total equivalent to approximately 44 percent of the Beneficial common stock that was allegedly sold in the offering. Within little more than a month after the last of these transactions had been effected, the price of Beneficial common stock jumped from \$7 5/8 to \$18, despite the fact there is no evidence in the record that would account for such a dramatic increase in the absence of manipulation. These circumstances support the determination of the court below that the appellants manipulated the trading of Beneficial common stock in violation Section 10(b) of the Securities Exchange Act as implemented by Rule 10b-5, a rule that is not to be read "restrictively" in cases involving manipulation. United States v. Charnay, 537 F. 2d 341, 349 (C.A. 9), certiorari denied, U.S. 97 S. Ct. 528 (1976).

C. The district court correctly found that the appellants Drucker, Kleinman, Commonwealth and DK & B had violated provisions of the Investment Company Act and the Investment Advisers Act

The appellants claim (Br. 22) that the district court "erroneously found 'self-dealing' and 'conflict of interest'" on the part of Messrs. Drucker and Kleinman, and Commonwealth and DK & B, in connection with various transactions involving the Hedge Fund and the Vanguard Fund. In this regard, they assert (Br. 23), without citing any authority for the proposition, that "Section 17(a) of the \* \* \* [Investment Company] Act prohibits direct sales only, making it clear that no violation can be established by tracing securities back to an 'affiliated person'" (emphasis in original). 40/ Section 17 of the Act, however, is not limited by its terms to "direct" sales. It makes it "unlawful [inter alia] for any affiliated person \* \* \* of \* \* \* a registered investment company \* \* \* or any affiliated person of such a person . . . knowingly to sell any security or other property to such registered [investment] company \* \* \*, unless the Commission grants "an application for an order exempting a proposed transaction \* \* \* from one or more provisions \* \* \* of that Section (emphasis added). 41/ If Commission approval is not obtained,

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40/ Messrs. Drucker and Kleinman, as officers and directors of the Hedge Fund and the Vanguard Fund, and as officers and directors of DK & B, were affiliated persons of the Fund within the meaning of Section 17(a) and Commonwealth was affiliated with them. See Section 2(a)(3) of the Investment Company Act, 15 U.S.C. 80a-2(a)(3).

41/ Section 17(b) of the Act, 15 U.S.C. 80a-17(b) provides, inter alia, that the Commission may grant such an application only if evidence establishes that

"(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(continued)

the sales violate Section 17(a) whether direct or, as here, through an intermediary broker (see pp. 15-18, supra.).

Section 17(a) required the appellants first to seek an exemption from the requirement of that section before effecting any transactions in securities between Commonwealth and either the Hedge Fund or the Vanguard Fund. In addition, the record clearly demonstrates (see pp. 15-20, supra) that Mr. Drucker "knowingly" brought about sales by Commonwealth of Beneficial securities and EDI shares to the funds on at least three separate occasions, by personally making arrangements with other broker-dealers to serve as intermediaries in effecting the transactions. The record also reflects that Mr. Kleinman assisted, on at least one occasion, in effecting such a transaction (Op. I 30; Tr. 40; App. 431a, 121a).

The appellants' assertion (Br. 23) that the transparent subterfuge of effecting these transactions indirectly involved "no illegal" act is completely without merit. Section 48(a) of the Investment Company Act makes clear that it is "unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of \* \* \* the Investment Company Act or of the rules promulgated thereunder. This provision was designed, among other things, to prevent efforts to evade the law through

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41/ (continued)

"(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under [the Act]; and

"(3) the proposed transaction is consistent with the general purposes of \* \* \* [the Act]."

the use of intermediaries. Accordingly, the court below properly found that Messrs. Drucker and Kleinman, and Commonwealth and DK & B, violated Sections 17(a) and Section 48 of the Investment Company Act by effecting transactions between the funds and Commonwealth without first making an application in each instance to the Commission for an exemptive order. 42/

II. THE ISSUANCE OF PERMANENT INJUNCTIONS AGAINST EACH OF THE APPELLANTS WAS A SOUND EXERCISE OF THE DISTRICT COURT'S DISCRETION

A. The district court's determination to grant injunctive relief should not be disturbed on appeal unless there has been a clear abuse of its discretion.

In an action involving "remedial" statutes, such as the Securities Exchange Act, 43/ a district court has broad discretion to enjoin, at the instance of the agency established by Congress to enforce those laws, possible future violations of law where past violations have been shown; and

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42/ Messrs. Drucker and Kleinman and Commonwealth and DK&B do not contest the district court's findings that they violated Section 36(a) of the Investment Company Act by "breaching their fiduciary duties toward the funds" (Op. I 41-42; App. 442a-443a), nor do they dispute the finding that they violated Section 37 of the Act by "using the assets of the funds in their unlawful scheme to inflate and artificially support the price of Beneficial securities and in 'dumping' large blocks of these watered securities on the funds \* \* \*" (Op. I 41-43; App. 442a-444a). In addition, Messrs. Drucker and Kleinman and DK&B do not challenge the finding of the court below (Op. I 43-44; App. 444a-445a) that they violated Section 206 of the Investment Advisers Act.

43/ See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 11-12 (1971). Cf., Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963), where the Supreme Court referred to an injunction obtained by the Securities and Exchange Commission as a "mild prophylactic" (id. at 193). This should be contrasted with the language appellants quote (Br. 25) from Securities and Exchange Commission v. Koracorp Industries, Inc., [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. 195,532 (N.D. Cal., 1976), appeal pending.

a lower court's determination that the public interest requires the imposition of a restraint should not be disturbed on appeal unless there has been a clear abuse of that discretion. Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1100 (C.A. 2, 1972); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 446 F. 2d 1301, 1306-1307 (C.A. 2), certiorari denied, 404 U.S. 1005 (1971); Securities and Exchange Commission v. Culpepper, 270 F. 2d 241, 250 (C.A. 2, 1959); Securities and Exchange Commission v. MacElvain, 417 F. 2d 1134, 1137 (C.A. 5, 1969), certiorari denied, 397 U.S. 972 (1970). In such actions, the Commission appears, "not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws." <sup>44/</sup> And, as the Court of Appeals for the Fifth Circuit has declared in an analogous context,

"the manifest difficulty of the Government's inspecting, investigating, and litigating every complaint of a violation weighs heavily in favor of enforcement by injunction—after the court has found an unquestionable violation of the Act."

Mitchell v. Pidcock, 299 F. 2d 281, 287 (C.A. 5, 1962) (emphasis in original).

As this Court has stated: "Surely the Commission should not be required to keep these appellants under surveillance and to bring a subsequent injunction action if they commence again" their unlawful activities. This Court has declined, in the past, to impose such a burden on the Commission. Securities and Exchange Commission v. Culpepper, 270 F. 2d 241, 250 (C.A. 2, 1959).

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<sup>44/</sup> Securities and Exchange Commission v. Management Dynamics, Inc., 515 F. 2d 801, 808 (C.A. 2, 1975); Securities and Exchange Commission v. Shapiro, 494 F. 2d 1301, 1308 (C.A. 2, 1974).

This Court and other courts of appeals have repeatedly held that the Commission has demonstrated the necessity for injunctive relief where there is a reasonable likelihood of future violations on the part of a defendant, and that a reasonable likelihood may be inferred by the district court from past violations. 45/ Moreover, the burden is on the party seeking to overturn the district court's exercise of discretion that an injunction should issue, and, as Manor Nursing holds, 458 F. 2d at 1100, "the burden necessarily is a heavy one." Clearly this Court should not disturb the district court's entry of injunctive relief on the basis of the appellants' self-serving assertions (Br. 27-29) that there is no likelihood that they will violate the federal securities laws in the future.

The appellants urge (Br. 27) that the Commission must show that the defendants have a "propensity for violation of the securities laws"

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45/ Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F. 2d at 807; Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1100; Securities and Exchange Commission v. Boren, 283 F. 2d 312, 313 (C.A. 2, 1960); Securities and Exchange Commission v. Culpepper, 270 F. 2d 241, 249-250 (C.A. 2, 1959). Cf. United States v. Diapulse Corp. of America, 457 F. 2d 25, 28-29 (1972); Securities and Exchange Commission v. First American Bank & Trust Co., 481 F. 2d 673, 682 (C.A. 8, 1973); Securities and Exchange Commission v. Advance Growth Capital Corp., 470 F. 2d 40, 53 (C.A. 7, 1972); Securities and Exchange Commission v. MacElvain, supra, 417 F. 2d at 1137; Securities and Exchange Commission v. Keller Corp., 323 F. 2d 397, 402 (C.A. 7, 1963); Los Angeles Trust Deed & Mortgage Exchange v. Securities and Exchange Commission, 285 F. 2d 162, 180-181 (C.A. 9, 1960), certiorari denied, 366 U.S. 919 (1961).

The "inference is even stronger when the wrongdoers insist [as in the instant case (see e.g. Br. 60)] that their actions are legitimate and do not violate the \* \* \* [law]". Securities and Exchange Commission v. First American Bank and Trust Company, supra, 481 F. 2d at 682; Accord, Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1101; Securities and Exchange Commission v. MacElvain, supra, 417 F. 2d at 1137.

in order to sustain the necessity for injunctive relief. This Court has stated, however, that "the use of either test [a propensity to violate the securities laws or a reasonable likelihood that the wrong will be repeated], if indeed they differ except in verbiage," is acceptable. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341, 394 (C.A. 2, 1973) (Gurfein, J.; Mansfield, J., concurring), certiorari denied, 414 U.S. 910 (1973). 46/ Thus the use of the reasonable likelihood standard does not differ from the standard the appellants urge and, in any event, is not an error as a matter of law. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., supra at 394.

There was plainly no abuse of discretion by the district court in enjoining Messrs. Drucker and Kleinman, Commonwealth and DK&B from engaging in future violations of the securities laws. Contrary to their assertion (Br. 28) that the record does not demonstrate "that any defendant has any history or pattern of violations of the securities laws," their violative conduct, as found by the court below (see, e.g., Op. I 47; App. 448a) was "repeated and persistent" and consisted of a series of egregious violations occurring over a period of more than a year. The record fully supports the court's determination (Op. I 48; App. 449a) that each of these appellants should be enjoined. Their "willful, blatant and \* \* \* completely outrageous" conduct 47/ cried out for the entry of permanent injunctive relief.

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46/ This Court went on to state: "We emphasize that we are not in the least interested in limiting the basis for an SEC injunction as a matter of law." Id. at 395.

47/ Cf. Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F. 2d at 1101.

In this regard, the appellants' assertion (Br. 28) that no defendant "has any history or pattern of violations" ignores the fact that Mr. Drucker <sup>\*/</sup> was preliminarily enjoined in another injunctive action brought by the Commission in the United States District Court for the Southern District of New York on November 26, 1976, 48/ and that Messrs. Drucker and Kleinman have been sanctioned by the Commission in administrative proceedings. 49/

The appellants also contend (Br. 29-30) that there is no need for an injunction because Messrs. Drucker and Kleinman have "voluntarily

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<sup>\*/</sup> The reference to Mr. Kleinman contained in our page proof brief at this point was in error. As defendants' reply brief pointed out (p. 10), Mr. Kleinman was not named as a defendant in another Commission injunctive action.

48/ Securities and Exchange Commission v. Robert C. Drucker, et al., No. 76 Civ. 2643 (MEL). The Commission's complaint alleged that appellant Drucker, Beneficial, defendant John Feldman and others had violated the registration and antifraud provisions of the federal securities laws by participating in a scheme: (a) to sell unregistered Beneficial common stock; and (b) to artificially raise and maintain the price of Beneficial common stock by manipulating the over-the-counter trading market for that security. On November 26, 1976, appellant Drucker, Beneficial and defendant Feldman were preliminarily enjoined, upon their consent, from violating the registration and antifraud provisions. See Litigation Release No. 7720, 11 SEC Docket 1400 (1976).

49/ While the first of two proceedings involving Messrs. Drucker and Kleinman and Commonwealth, In the Matter of Commonwealth Chemical Securities, Inc., et al., was based largely on the same conduct that is the subject of the Commission's complaint in the instant action (see Securities and Exchange Act Release No. 11018, 5 SEC Docket 155 (1974)); the second proceeding, In the Matter of S. J. Salmon Co., Inc., et al., was based on allegations that Messrs. Drucker and Kleinman, Commonwealth and others had "violated the antifraud provisions of the Federal securities laws in that each of them, at various times from June 1969 to June 1972, manipulated the price of some or all of 26 different securities enumerated in the order for proceedings." See Securities and Exchange Act Release No. 11045, 5 SEC Docket 273, 274 (1974).

Messrs. Drucker and Kleinman, and Commonwealth consented to the entry of a Commission order, in settlement of both proceedings, that revoked the broker-dealer registration of Commonwealth and barred Messrs. Drucker and Kleinman from association with any broker-dealer, investment company, or investment adviser. See Securities Exchange Act Release No. 11782, 8 SEC Docket 326 (1975). The order also provided that Messrs. Drucker and Kleinman could apply to the Commission after two years for permission to become so associated in a non-supervisory capacity, upon a proper showing that they would be supervised. (Id.)

terminated all broker dealer activities \* \* \* and may [not] return to the securities business without the consent of \* \* \* the Commission. This argument refers to the fact that these appellants consented to the entry of a Commission order, in settlement of the two separate administrative proceedings that had been instituted against them (see n. 49, supra), that revoked the broker-dealer registration of Commonwealth and barred Messrs. Drucker and Kleinman from association with any broker-dealer, investment company or investment adviser. The Commission order, however, does not provide relief comparable to that provided by an injunction. 50/ The injunction is enforceable by contempt proceedings if any of the appellants should engage in further violations of the securities laws. In contrast, the Commission's administrative order would have to be enforced, if violated, by a court order, and that court order violated, as well, before contempt proceedings could be instituted. In addition, although the Commission's order does bar Messrs. Drucker and Kleinman from the securities business, it does not prohibit further violations of the securities laws. Accordingly, absent the injunction, Messrs. Drucker and Kleinman would be free again to violate the securities laws, or aid and abet the violations of others, without fear that they would be subject to contempt proceedings.

In addition, the court below did not abuse its discretion in determining that appellants Sharpe and Marlane Kleinman should be enjoined. With respect to appellant Sharpe, the court found (Op. I 13; App. 414a) "on a balance

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50/ Cf. Mitchell v. Pidcock, supra., 299 F. 2d at 287. See also Virginia Ry. Co. v. System Federation No. 40, Etc., 300 U.S. 515, 552 (1937).

of all the evidence, including \* \* \* [her] relationship as Commonwealth's bookkeeper, the timing of the transaction, the then significance of 1,000 units to the target quantity [for the closing] , and the spurious explanation \* \* \* [she gave] on the [witness] stand, that Sharpe was knowingly attempting to aid and participate in the fraudulent closing of the offering, with some stake in its success \* \* \*" at the time she purchased 1,000 of the Beneficial units in her mother's name.

In the case of Marlane Kleinman, who is the wife of appellant Julius Kleinman, the court noted (Op. I 27-28; App. 428a-429a) that it "is not disputed" that she engaged in certain transactions in Beneficial units after the closing of the offering; that her transactions "more or less coincided with the manipulations of [Messrs.] Drucker and Kleinman \* \* \*"; and that "[a]t no time did \* \* \* [she] offer any evidence to refute any of the charges made against her." 51/

The court found also (Op. I 27; App. 428a) that appellants Sharpe and Marlane Kleinman were \* \* \* inextricably linked to \* \* \*<sup>51/</sup> Messrs. Drucker and Kleinman "and that a fair preponderance of the evidence indicates that they must have known of the fraudulent scheme." On this basis, the court concluded (Op. I 48-49; App. 449a-450a): (a) that appellants Sharpe and Marlane Kleinman "were not innocent bystanders but insiders who attempted to exploit the illegal activities of [Messrs.] Drucker and Kleinman for their own gain, thus lending assistance to the unlawful plan"; and (b) that there

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51/ Marlane Kleinman failed, as did her husband, to testify at the trial. As with him, (see p. 29, supra), her failure to testify warrants an inference that her testimony would have been "unfavorable" to her defense. See N. Sims Organ & Co. v. Securities and Exchange Commission, 293 F. 2d 78, 80-81 (C.A. 2, 1961), certiorari denied, 368 U.S. 908 (1962).

was "no reason to believe that, should a similar opportunity [to violate the securities laws] arise in the future, they would shy away." 52/ Accordingly, the court below properly determined that the public required the protection of an injunction against future violations of the securities laws by each of these appellants.

B. The District Court Properly Found That Appellants had Violated, or Aided and Abetted Violations of the Securities Laws.

1. The Court Below Determined That Messrs. Drucker and Kleinman, and Commonwealth and DK & B, had Engaged in Intentional Violations of the Securities Laws; Accordingly, Their Assertion That the Court Based its Findings With Respect to Their Conduct on a "Negligence Standard" is Wholly Without Merit.

The appellants erroneously assert (Br. 42) that the court below found "all" of the appellants to have violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder "based on the application of a negligence standard". Even if it were relevant to the propriety of injunctive relief, which it is not, this assertion is inaccurate. The court below made clear in its findings of fact that the conduct of Messrs. Drucker, Kleinman and Commonwealth was knowing, purposeful and intentional.

The court held, for example (Op. I 34-35; App. 435a-436a), that Messrs. Drucker and Kleinman, and Commonwealth, "knowing that sales to the public were falling short of the \* \* \* 50,000 unit minimum [necessary to hold a closing of the Beneficial offering], disguised the investing public's rejection of the offer by spurious sales to controlled accounts and by closing the issue knowing full well that 50,000 units had not been sold" (emphasis added). The court

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52/ In this regard, appellant Sharpe "is presently a bookkeeper for a brokerage firm" (Br. 28) and thus appears to be in a position to engage in further violations of the kind involved in the instant case.

added (Op. I 35; App. 436a), "There can be no question that \* \* \* [this] conduct constitutes a scheme, artifice and device to defraud by means of both false representations and non-disclosure of material facts \* \* \*." Furthermore, the court found (Op. I 40; App. 441a) that these appellants "commenced trading in Beneficial securities [after the closing] in a manner calculated to inflate their price artificially" (emphasis added) and that their violative conduct included the "dominance of the market by [twelve] accounts under their direct control, the manipulation of the market through prearranged swap transactions and the sale of substantial blocks of these securities to the Hedge and Vanguard Funds \* \* \*." The court also determined (Op. I 42; App. 443a), with respect to the fund transactions, that these appellants had "acted purposefully in their dual and conflicting roles \* \* \* [by] placing large blocks of Beneficial securities with the funds at the same time they were artificially inflating the price of the securities \* \* \*" (emphasis added).

These statements manifest the district court's conviction that these appellants had engaged in knowing and intentional violations of Section 10(b) and Rule 10b-5 of the Securities Exchange Act.

2. The District Court's Finding That Appellants Sharpe and Marlane Kleinman Negligently, if not Knowingly, Aided the Violations was a Proper Basis for Enjoining Them.

In the instant case, the district court found (Op. I 48-49; App. 449a-450a) that appellants Sharpe and Marlane Kleinman assisted Messrs. Drucker and Kleinman in carrying out their violative conduct. "[O]n a balance of all the evidence," the district court found that "Sharpe \* \* \* and Marlane Kleinman were in a position to know of the illegal scheme, saw an opportunity to make substantial profits, participated in the trading, and negligently if not knowingly, aided

the manipulation" (Op. I 29; App. 430a). Moreover, it held (Op. I 45-56; App. 446a-457a) that appellants Sharpe and Marlane Kleinman should have known of the scheme to defraud, and should have known, "in the exercise of reasonable care," that their actions would aid and abet that scheme. The harm to the public is the same regardless of their state of mind. "This was a scheme," as the district court declared (Op. I 29; App. 430a) "in which 'every little bit helps,' and these \* \* \* [appellants], dependent upon \* \* \* [Messrs.] Drucker or Kleinman, dutifully assisted the unlawful plan."

While the foregoing evidences that the district court believed that appellants Sharpe and Kleinman were guilty of more than mere negligence, the appellants insist that the findings against Sharpe and Kleinman were based on a finding of negligence and assert that such a standard cannot be applied under present law.

The appellants state (Br. 42-46) that the Supreme Court, in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), held the negligence standard "to be incorrect", absent a finding of scienter, in the context of a civil action for damages brought under Section 10(b) and Rule 10b-5. They also assert (Br. 43-44) that the Hochfelder rationale "applies equally in a suit by the SEC for injunctive relief."

Hochfelder held that a private party could not recover damages under Section 10(b) of the Securities Exchange Act and Rule 10b-5 against an accountant for alleged negligence in connection with its audit of a broker-dealer. The plaintiff there contended that a more careful audit might have uncovered facts sufficient to arouse a suspicion of fraud, that such suspicion should have led to further inquiry, and that such inquiry might have

led to discovery of the broker-dealer's fraud against the plaintiff. The plaintiff did not contend, however, that the defendants, in fact, knew of the fraud. The Supreme Court held, under these circumstances, that the language and legislative history of Section 10(b) demonstrated that the Section was not intended to be the basis for private damage actions in the absence of "scienter." More recently, in the context of another private damage action, the Supreme Court described its holding in Hochfelder as stating that "a cause of action under Rule 10b-5 does not lie for mere negligence \* \* \*." Santa Fe Industries v. Green, 45 U.S.L.W. 4317, 4320 (March 23, 1977).

The Hochfelder court specifically left open "the question whether scienter is a necessary element in an action for injunctive relief under Section 10(b) and Rule 10b-5." Subsequent to Hochfelder, this Court made clear the law in this Circuit, that "in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter is not required" (emphasis added). Securities and Exchange Commission v. Universal Major Industries, 546 F. 2d 1044, 1047 (1976). 53/ Moreover, two of the decisions cited in Universal Major Industries as

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53/ Universal Major Industries involved Section 5 of the Securities Act, whereas the instant action was brought pursuant to Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. But that fact in no way detracts from this Court's explicit statement in Universal that negligence alone is a sufficient basis upon which to predicate a cause of action in a Commission suit for equitable relief. As this Court recognized in Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541 n. 12, (1973), it has "enunciated the negligence test principally in cases involving the anti-fraud provisions of the securities laws \* \* \*." The vitality of the Spectrum decision was specifically reaffirmed by this Court in its Universal Major Industries decision, 546 F. 2d at 1046-1047.

representing "the law of this Circuit," and, thus, as possessing continued vitality, are the very same decisions upon which the district court relied (Op. I 45-46; App. 446a-447a) in holding that appellants Sharpe and Marlane Kleinman had aided and abetted violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. 54/

The repeated and consistent decisions of this Court holding that negligence is the proper standard in Commission actions for equitable relief, 55/ can be traced to the Supreme Court's teachings in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). In Capital Gains, the Supreme Court held that "[i]t is not necessary

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54/ Securities and Exchange Commission v. Management Dynamics, Inc.,  
supra 515 F.2d 801; Securities and Exchange Commission v. Spectrum,  
Ltd., supra, 489 F.2d 535.

55/ See Securities and Exchange Commission v. Management Dynamics, Inc.,  
supra, 515 F.2d 801; Securities and Exchange Commission v. Spectrum,  
Ltd., supra, 489 F.2d 535; Securities and Exchange Commission v.  
Everest Management Corp., 475 F.2d 1236, 1240 (C.A. 2, 1972);  
Securities and Exchange Commission v. North American Research &  
Development Corp., 424 F.2d 63 (C.A. 2, 1970); Securities and  
Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d 833;  
Cf. Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.  
2d 171, 180-181 n. 6 (C.A. 2, 1976), rehearing denied, 551 F. 2d 915  
(1977); Hanly v. Securities and Exchange Commission, 415 F.2d 589, 596  
(C.A. 2, 1969). Other courts of appeals have also held that negligence  
is a sufficient predicate for a cause of action by the Commission. See,  
e.g., Securities and Exchange Commission v. Dolnick, 501 F.2d 1279, 1284  
(C.A. 7, 1974); Securities and Exchange Commission v. Pearson, 426 F.2d  
1339, 1343 (C.A. 10, 1970); Securities and Exchange Commission v. Van  
Horn, 371 F.2d 181, 186 (C.A. 7, 1966); Securities and Exchange Com-  
mission v. Geotek, CCH Fed. Sec. L. Rep. ['76-'77] ¶95,756 (N.D. Cal.,  
1976). See, e.g., Securities and Exchange Commission v. Trans Jersey  
Bancorp, CCH Sec. L. Rep. ['76-'77] ¶95,818 (D. N.J., 1976). Contra  
Securities and Exchange Commission v. Bausch & Lomb, Inc., et al.,  
420 F. Supp. 1226, (S.D. N.Y., 1976), appeal pending; Securities and  
Exchange Commission v. Coffey, 493 F.2d 1304 (C.A. 6, 1974), certiorari  
denied, 420 U.S. 908 (1975); Securities and Exchange Commission v.  
American Realty Trust, CCH Fed. Sec. L. Rep. ['76-'77] ¶95,913 (E.D.  
Va., 1977).

in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." Id. at 193. It continued:

"To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute." Id. at 200. 56/

This Court's recent affirmation of the negligence standard in Commission actions for equitable relief in Universal Major Industries is the same result, moreover, that was reached by the only other appellate court to consider this question since Hochfelder. In Securities and Exchange Commission v. World Radio Mission, Inc., 544 F.2d 535, 540-541 (C.A. 1, 1976), the United States Court of Appeals for the First Circuit rejected the defendants' contentions that they had not acted with intent to deceive and that, therefore, an injunction should not issue, stating:

"From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendant's state of mind is irrelevant. If proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however much it may be a defense to a private suit for past actions, see Ernst & Ernst v. Hochfelder \* \* \*, should make no difference. Cf. SEC v. Capital Gains Research Bureau, Inc., ante."

As the First Circuit noted in World Radio Mission (id.), this Court "correctly anticipated the Hochfelder outcome and required proof of scienter in private damage actions under rule 10b-5, see, e.g., Lanza v. Drexel & Co., 2 Cir., 1973, 479 F.2d 1277, \* \* \* [and has] not considered intent relevant

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56/ Significantly, it was Capital Gains that the Supreme Court referred to in Hochfelder when it noted that equitable actions under Rule 10b-5 might involve different standards of conduct than actions for money damages. Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 194 n. 12.

in SEC injunction actions, see, e.g., SEC v. Shapiro, 2 Cir., 1974, 494 F.2d 1301, 1308." These decisions are wholly consistent with the proposition, as the First Circuit declared (id.), that "[a]n injunction is designed to protect the public against conduct, not to punish a state of mind. Hecht Co. v. Bowles, 1944, 321 U.S. 321, 329 \* \* \*" (footnote omitted) (id.).

The Hochfelder holding reflects the Supreme Court's concern that adoption of a negligence standard in private damage actions would both disrupt the statutory scheme of the "carefully drawn express civil remedies" in the Securities Act and the Securities Exchange Act 57/ and "would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts," 58/ with the consequent spectre of "liability in an indeterminate amount for an indeterminate time to an indeterminate class." 59/ Such concerns, while relevant to a private damage action such as Hochfelder, are inapplicable to the instant action for equitable relief, which was instituted pursuant to the express provisions of the securities laws. In Commission actions, where the Commission appears "not as an ordinary litigant but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws," it must only establish what the statute requires. 60/ "'Proof of irreparable injury or the inadequacy

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57/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 200-201.

58/ Id. at 214 n. 33.

59/ Id. at 215 n. 33, quoting from Ultramarine Corp. v. Touche, 255 N.Y. 170, 179-180, 174 N.E. 441, 444 (1931).

60/ 3 L. Loss, Securities Regulation, 1979 (2d ed., 1961) (footnotes omitted). Unlike private plaintiffs, if the Commission is denied relief, it has no remedy at law which it might choose to pursue.

of other remedies as in the usual suit for injunction' is not required." 61/

Private damage actions, unlike Commission actions seeking to protect public investors from future violations, are retrospective only, and are intended to provide monetary redress to the plaintiffs, and often others similarly situated, for past violative conduct. In light of these significant differences in the nature and purpose of Commission injunction actions vis-a-vis private actions, a scienter requirement in Commission actions, and the resulting burden of proof such a standard would impose on the Commission, would only serve to hamper, not further, the broad remedial purposes of the federal securities laws. 62/ We respectfully submit that the negligence standard consistently applied by this Court in Commission injunctive actions is appropriate and that the court below applied a correct legal standard in finding that appellants Sharpe and Marlane Kleinman had aided and abetted violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder.

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61/ Securities and Exchange Commission v. Management Dynamics, supra,  
515 F.2d at 808.

62/ The Supreme Court has repeatedly emphasized that the federal securities laws should be construed broadly and flexibly to effectuate their remedial purposes. Santa Fe Industries, Inc., v. Green, supra, 45 U.S.L.W. at 4320-4321; Superintendant of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

III. THE APPELLANTS WERE PROPERLY ORDERED TO DISGORGE THEIR PROFITS RESULTING FROM THEIR ILLEGAL MANIPULATION OF THE MARKET OF BENEFICIAL LABS, INC., SECURITIES

A. Appellants are not entitled to a jury trial on the ancillary relief of disgorgement of profits in an equitable action brought by the Commission.

As we have seen (pp. 5-6, supra), the district court not only enjoined appellants but as ancillary relief directed them to give up the gains from their manipulation of the market for Beneficial stock. This Court has emphasized in Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (1972):

"The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect on an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits."

Thus, this Court and other courts have repeatedly upheld the Commission's authority to seek, and the district court's power to grant, relief ancillary to the injunctive relief the Commission is specifically authorized to obtain under Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d). 63/ Judge Weinfeld recently stated, in denying a request for a jury trial in an

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63/ See, e.g., Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1309 (C.A. 2, 1974) (trustee and disgorgement); Securities and Exchange Commission v. Koenig, 469 F.2d 198, 202 (C.A. 2, 1972) (receiver); Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103-1106 (C.A. 2, 1972) (trustee and disgorgement); Securities and Exchange Commission v. Investors Security Corp., CCH Fed. Sec. L. Rep. [Current] ¶96,120, p. 92,038 (C.A. 3, 1977) (receiver); Securities and Exchange Commission v. Bowler, 427 F.2d 190, 197-198 (C.A. 4, 1970) (receiver); Securities and Exchange Commission v. Bartlett, 422 F.2d 475, 477-479, (C.A. 8, 1970) (receiver); Securities and Exchange Commission v. Keller Corp., 323 F.2d, 397, 403 (C.A. 7, 1963) (receiver); Securities and Exchange Commission v. R. J. Allen & Associates, 386 F. Supp. 866 (S.D. Fla., 1974) (receiver and disgorgement); Securities and Exchange Commission v. Golconda Mining Company, 327 F. Supp. 257, 259-260 (S.D. N.Y., 1971) (disgorgement).

injunction action in which the Commission sought disgorgement, that disgorgement "springs out of the policy of public enforcement of the securities laws and exists as an exercise of the equity powers of the federal courts." 64/

Appellants suggest (Br. 35) that the disgorgement of profits in this action "serves the same function, makes the same claims and seeks the same relief" as a claim for damages by a private party. This statement demonstrates appellants' misunderstanding of the authority of the Commission and the courts under Section 21(d) of the Securities Exchange Act and their misunderstanding of the purpose of disgorgement. The statute authorizes the Commission to seek and the court to grant equitable relief that will prevent future violations. Even the threat of contempt may be insufficient to accomplish this, however, if defendants may keep large sums that may result from violations. Thus the purpose of the disgorgement sought is to deter future violations and at the same time to vindicate the public interest. Nor is there any necessary correlation between the amount of profit to the wrongdoer from his illicit activities and damages inflicted on the public. 65/

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64/ Securities and Exchange Commission v. Petrofunds, Inc., 420 F. Supp. 958, 960 (S.D. N.Y., 1976), appeal dismissed with prejudice, No. 76-1684 (C.A. 2, April 13, 1977). See, also, Securities and Exchange Commission v. Associated Minerals, Inc., Civil Action No. 7-70986 (E.D., Mich., July 8, 1977), where a request for a jury trial was denied in an action in which the Commission sought disgorgement.

65/ For example, the Commission has never sought disgorgement from an officer of a publicly-held company who has made false and misleading statements which have injured public investors; but where such an individual has traded on inside information (or has enabled someone else to trade on such information), the Commission has requested that any profits from such trading be disgorged. And, in light of the fact that such relief is sought in the public interest, the wrongdoers are not entitled to the return of any unclaimed portion of "their ill-gotten profits." Securities and Exchange Commission v. Golconda Mining Co., supra, 327 F. Supp. at 259. As there pointed out by Judge Weinfeld (id. at 259-260): "The injunction against future violations, while of some deterrent force, is only a partial remedy since it does not correct the

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The fact that there may be an incidental benefit to private investors from the relief granted to effectuate a public policy does not change the nature of this action from one in equity to one at law. 66/ Thus divestiture "is restorative of the status quo, which falls within the recognized power of a court of equity." Bowles v. Skaggs, 151 F.2d 817, 821 (C.A. 6, 1945). "Like restitution [i.e., disgorgement] merely deprives a defendant of the gains from his wrongful conduct." Schine Chain Theatres, Inc. v. United States, 334 U.S. 110, 128 (1948); accord, Securities and Exchange Commission v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (C.A. 2), certiorari denied, 404 U.S. 1005 (1971). 67/ As the court noted in Securities and Exchange Commission v. R. J. Allen & Associates, Inc., supra, 386 F. Supp. at 880:

"In dealing with plaintiff's prayer for disgorgement, this Court equates disgorgement with restitution and recoupment which are equity remedies of ancient origin. When Congress entrusts to an equity court the enforcement of prohibitions contained in a regulatory enactment, it must be taken to have acted cognizant of the historic power of equity to provide complete relief in light of statutory purposes."

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65/ (continued)

consequences of past conduct. To permit the return of the unclaimed funds, a portion of the illicit profits, would impair the full impact of the deterrent force that is essential if adequate enforcement of the securities acts is to be achieved. One requirement of such enforcement is a basic policy that those who have engaged in proscribed conduct surrender all profits flowing therefrom."

66/ In this connection, appellants' reliance (Br. 39) on Ross v. Bernhard, 396 U.S. 531 (1970), in asserting the proposition that the claim for money to be distributed to investors is essentially a legal claim and not one which is converted into an equitable claim merely by being characterized as "ancillary," is misplaced. While the Ross case stands for the proposition that the right to a jury trial attaches to those issues in derivative actions brought by the stockholders of a corporation as to which the corporation, if it had been suing in its own right, would have been entitled to a jury, nowhere does the Court identify disgorgement as a legal remedy.

67/ See also Mitchell v. Robert DeMario Jewelry, 361 U.S. 288 (1960); United States v. Moore, 340 U.S. 616 (1951); Porter v. Warner Holding Co., 328 U.S. 395 (1946).

And as stated by the district court in Securities and Exchange Commission v. Texas Gulf Sulphur Company, 312 F. Supp. 77, 92 (S.D. N.Y., 1970), the purpose of disgorgement is:

"\* \* \* to deprive the defendants of their profits in order to remove any monetary reward for violating Section 10(b) and Rule 10b-5, [and] the SEC is urging this court to provide a remedy which, in accord with the congressional purpose of the 1934 Act, will protect the investing public by providing an effective deterrent to future violations. Accordingly, the court may require the defendants to give up profits realized on transactions which violated Section 10(b) and Rule 10b-5."

Disgorgement is in many respects comparable to the traditional equitable remedy of accounting. In Securities and Exchange Commission v. R. J. Allen & Associates, Inc., *supra*, 386 F. Supp. at 880, the court noted that the Commission's request for ancillary relief in the form of an accounting by the defendants in order to aid the court and its receiver in determining the amounts to be disgorged is a proper exercise of the court's equitable power.

Appellants' attempt (Br. 37-38) to bolster their argument, which equates disgorgement with a private action for damages, by referring to Securities and Exchange Commission v. Penn Central Company, 425 F. Supp. 593 (E.D. Pa., 1976). Yet some of the very language quoted by appellants demonstrates the distinction between the Commission's acting in accordance with its responsibilities on behalf of the public interest and suits of private parties for money damages (*id.* at 599):

"Private suits do not restore the status quo. Disgorgement contemplates total recovery from the wrongdoer, not recovery that may be partial or limited to a few of the total number injured or subject to a compromise of actual damages.

\* \* \*

"The SEC in bringing this action is attempting to enforce effectively the federal securities laws under its statutory mandate. It is true that if the government prevails and disgorgement is ordered, private parties may be able to claim some of the disgorged funds. But this is not predominately an action for restitution for the benefit of private parties. The fact that one consequence of the action may be to benefit private parties does not detract from the public purpose of effectuating the goals of the securities laws."

With respect to similar arguments raised by defendants, who sought a jury trial, Judge Weinfeld noted in Securities and Exchange Commission v. Petrofunds, Inc., supra, 420 F. Supp. at 960:

This argument, however, ignores the critical distinction between actions brought by the SEC and actions brought by private litigants. Regardless of the fact that the defendants may be required to disgorge profits, the SEC in no way stands in the shoes of a private litigant with respect to its claims for ancillary relief. Indeed, the entire purpose and thrust of an SEC enforcement action is expeditiously to safeguard the public interest by enjoining recurrent or continued violations of the securities acts. The claims for relief asserted in such an action stem from, and are colored by, the intense public interest in SEC enforcement of these laws.

Curtis v. Loether, 415 U.S. 189 (1974), on which appellants rely (Br. 32-35), involved the question of a right to a trial by jury in an action brought under Section 812 of the Civil Rights Act of 1968, 42 U.S.C. 3612, dealing with fair housing. Unlike Section 21(d) of the Securities Exchange Act, an injunction statute, Section 812, the fair housing section, specifically provides that "[t]he court may grant \* \* \* [an] injunction, \* \* \* and may award to the plaintiff actual damages \* \* \*" (emphasis supplied). As the Court stated in affirming the right to a jury trial in that case: "The Seventh

Amendment does apply to actions enforcing rights, and requires a jury trial upon demand, if the statute creates legal rights and remedies, enforceable in an action for damages in the ordinary courts of law." 415 U.S. at 194. 68/ In comparing that section with provisions in Title VII of that Act. where back pay has been awarded "as an integral part of an equitable remedy, a form of restitution" (id. at 197), the Court noted (id.) that the statutory language of Title VII "contrasts sharply with §812's simple authorization of an action for actual and punitive damages" brought by a private plaintiff.

B. The District Court's Calculations of the Amounts the Appellants Should Disgorge are Based on Proper Considerations.

The district court found (Op. I 20; App. 421a; See pp. 32-33, supra) that the charts prepared by Mr. Judkowitz concerning the trading by the defendants of Beneficial common stock, warrants and units (PX 7, 9 and 10; App. 80a, 89a, 93a) "reveal with a reasonable degree of accuracy what they purport to show, that is, trades in Beneficial securities in which market makers were involved." In addition, in computing the amounts to be disgorged on the basis of those charts, the court was "mindful" (Op. II 5; App. 463a): (a) that a disgorgement order "may not be punitive in nature", and (b) that the amounts to be disgorged could "only be a reasonable estimate based upon the evidence \* \* \*."

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68/ The Court reaffirmed (id. at 193) the basic principle established by Mr. Justice Story in Parsons v. Bedford, 3 Pet. 433, 446 (1830):

"The phrase "common law," found in [the Seventh Amendment], is used in contradistinction to equity \* \* \*."

In the light of these considerations, the court below determined (id.) that the "most equitable" method of calculating the amounts to be disgorged, of four methods proposed by the parties, was a method (Method II) that resulted in the lowest aggregate sum to be disgorged of the four alternatives considered. In fact, the method chosen produced a lower computation of the total amounts to be disgorged than either of the methods proposed by the appellants. 69/

The district court agreed with the Commission that the purchases and sales should be matched on a "first-in-first-out" basis, unless a purchase and sale of the same number of shares of a security occurred on the same day. In that event, such purchases and sales were "directly matched" (Op. II 2; App. 460a). As the court noted, the last-in-first-out method urged by the appellants "gives a defendant an inflated purchase price basis for his sale transaction" (Op. II 6; App. 464a).

In computing the amounts the appellants were ordered to disgorge, however, the court determined important questions in their favor. It considered the fact that "in several accounts the number of securities sold exceeds the number purchased" (Op. II 2, 5; App. 460a, 463a); and, rather than "borrowing" securities from other accounts controlled by a particular defendant

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69/ As noted at page 6, supra, the judgment directed that a total of \$405,541 be disgorged. The court below designated the appellants' methods of computation, as set forth by the Commission, based on its charts, as Methods III and IV. Using these suggested methods, the court determined that Method III would result in disgorgement of a total of \$529,761 and that Method IV would require disgorgement of \$573,274. (See Op. II, Table 2; App. 467a). Each of these proposals would have required Commonwealth to be responsible for most of the sum to be disgorged (Op. II 6; App. 464a).

"[i]n order to fix a price basis for computing profits on such excess sales," as the Commission had proposed, the court determined that "[a]ll excess sales would simply be disregarded" (Op. II 2-3, 5-6; App. 460a-461a; 463a-464a). 70/ Moreover, although the court recognized that defendant Commonwealth "may be judgment-proof" (Op. II 6; App. 464a), it determined not to hold Messrs. Drucker and Kleinman each "responsible for one-half of the profits realized in the Commonwealth trading account," as the Commission had suggested (Op. II 2-3, 5-6; App. 460a-461a, 463a-464a). 71/ This latter determination alone had the effect of reducing the total sum to be disgorged by Messrs. Drucker and Kleinman by more than \$189,000 (see Op. II table 2; App. 467a).

Despite these determinations to their advantage, the appellants contend that the district court's calculations of the amounts to be disgorged are "clearly erroneous" (Br. 47). The appellants urge, in this regard (Br. 47-51), that the charts used to make the computations (PX 7, PX 9 and PX 10; App. 80a, 89a, 93a) are inaccurate and incomplete. They assert (Br. 48) that "[a] full recitation of defendants' purchases and sales would be contained in the periodic statements received by the defendants from the various broker-dealers with whom they maintained accounts." The trading charts were prepared, however, on the basis of the original records of the

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70/ The appellants argue (Br. 49) that PX 10 "shows Mr. Drucker selling 1000 [Beneficial] units in October, 1972, and 1250 [Beneficial] units in November, 1972, but \* \* \* fails to show any purchases \* \* \* of such units. They also contend (Br. 49) that the "failure" to consider the cost of purchasing those units "severely distorted the profit calculation. This contention ignores the district court's disregard of all such "excess sales" in computing the amounts to be disgorged.

71/ The court held that, although the "evidence \* \* \* supports the inference that the individual defendants directly profited from their controlled accounts," Commonwealth was a corporate entity named as a separate defendant and there was "no evidence that \* \* \* [Messrs. Drucker and Kleinman] used their own funds to purchase through Commonwealth on sale transactions" (Op. II 5-6, See Tr. 5-9, 11, 14-15; App. 463a-464a, 99a-103a; 105a; 106a-107a).

transactions or their confirmations, records that presumably are more accurate and more complete than the monthly statements appellants might have received from various broker-dealers (see supra, pp. 32-33). Moreover, defendants did not put these monthly statements in evidence, so it is impossible for this Court to determine whether there is in fact any discrepancy between the trading charts and the monthly statements. 72/

In this connection, appellants suggest (Br. 48) that the chart upon which the court based its computations may not have contained all the trades in which they participated; but, as we have seen, pp. 32-33, supra, the Commission's charts contained all transactions except private sales or purchases in which the appellants may have engaged. Appellants failed to offer evidence of such private transactions but presumably would have, if these would have diminished their profits. 73/

An additional claim (Br. 51) involves the alleged failure of PX 9 "to include a purchase" by Commonwealth of 2,000 Beneficial warrants on January 15, 1973, and the assertion that inclusion of that transaction would have reduced the profits to be disgorged by Commonwealth. Both PX 9 and the order ticket (see PX 8; App. 87a-88a) reflect, however, that Commonwealth was acting as agent for defendant Drucker on that date in effecting a sale of the 2,000 warrants to another broker-dealer. Moreover, PX 9

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72/ Even if the monthly statements were in evidence, and discrepancies did exist between the statements and the original records, the district court might well have determined that the monthly statements rather than the original records, were inaccurate. In this regard, it is significant that Messrs. Drucker and Kleinman and Commonwealth were found to have violated the bookkeeping requirements by recording the "names of fictitious subscribers" to the offering in Commonwealth's books and records (see Op. I 39; App. 440a).

73/ Appellant Drucker unsuccessfully attempted to put certain charts in evidence, but these were not admitted because no proper foundation had been laid (Tr. 300-302, 379-383; App. 271a-278a; 347a-351a).

clearly reflects that, even if such a purchase had occurred, it would not have had any effect on the amount to be disgorged because Commonwealth did not engage in any sale after that date with which the purchase could have been matched.

Appellants also claim (Br. 49) that PX 7 "shows Mr. Drucker to be a seller of 10,000 shares of Beneficial \* \* \* common stock" when in fact he was "only one of several sellers, to the extent of 3,250 shares" (Br. 49-50). The original order ticket (see PX 8; App. 87a-88a) does reflect that appellant Drucker sold 3,250 shares, that the account of Lori Rukasin, which he controlled, sold 3,500 shares and that appellant Julius Kleinman sold 3,250 shares. Because the court properly found that appellant Drucker should be required to disgorge any profits realized in the accounts he controlled, he should be held responsible for the sale of at least 6,750 shares.

The appellants contend (Br. 53-55) that the court below should have disregarded profits realized in transactions between various defendants on the premise that the "only permissible function of disgorgement is to return profits realized from the public." They contend, in this regard (Br. 54), that because "no public person suffered any loss in connection with any transaction between defendants," the disgorgement of such profits "would be a pointless and punitive act \* \* \*." As we have seen, however, (pp. 56-58, supra) the appellants misperceive the function of disgorgement. The purpose of the disgorgement remedy is not to compensate investors for any losses they have suffered in dealing

with various defendants, although this may be an incidental effect in some cases. Instead, as the court below noted (Op. I 49; App. 450a), the purpose is "'to make violations [of the securities laws] unprofitable' \* \* \*." From the perspective of a disgorgement remedy, it makes no difference whether the sums disgorged are distributed to investors, donated to a charity or disposed of in some other manner, as long as wrongdoers are deprived of the profits of their violative conduct. See pp. 56-59, supra. Accordingly, the court below properly determined (Op. II 6; App. 464a) that "a defendant who makes a profit on a sale to another defendant should justly be held accountable."

The appellants also assert (Br. 55-56) that the district court erred in failing to consider the decline in the value of their Beneficial securities after the Commission suspended the trading of such securities on March 5, 1973. In addition, they assert that the "losses" they sustained after trading was suspended "more than offset [the] profits realized \* \* \*" prior to the suspension. The district court pointed out (Op. I 50; App. 451a), however, that the trading suspension "occurred because of their own wrongdoing." It correctly held (id.) that "[t]o allow \* \* \* [the appellants] to credit their subsequent losses against their prior gains would \* \* \* permit them to profit from their own wrongs."

The appellants claim (Br. 52-53), in addition, that the court erroneously required Messrs. Drucker and Kleinman to disgorge the profits realized in controlled accounts. They argue (Br. 52-53) that there is no finding that either appellant "received any funds" from the controlled accounts. The district court expressly found, however (Op. II 5-6; App. 463a-464a) that the "evidence \* \* \* supports the inference that \* \* \* [Messrs. Drucker and Kleinman] directly profited from their controlled accounts." This inference finds

support in the testimony of three persons whose names were listed as the beneficial owners of certain accounts controlled by Messrs. Drucker and Kleinman.

Lori Rukasin, appellant Drucker's sister-in-law, testified that she did not maintain a brokerage account in her name at Commonwealth (Tr. 5-6; App. 99a-100a) that she did not authorize anyone else to do so (id.) that she did not purchase or sell any Beneficial securities (Tr. 7-8; App. 101a-102a) and that she did not even know "that a brokerage account was being maintained in \* \* \* [her] name at Commonwealth \* \* \* " until she received a Commission subpoena in 1974 (Tr. 8-9; App. 102a-103a).

Similarly, Dorothy Drucker, appellant Drucker's wife, testified that she did not maintain a brokerage account at Commonwealth, did not purchase or sell any Beneficial securities and did not authorize any other person to purchase or sell Beneficial securities on her behalf (Tr. 14-15; App. 106a-107a). She also stated (Tr. 15; App. 107a) that, although she eventually did become aware that an account had been opened in her name at Commonwealth, she never received any statements or confirmations concerning the account.

Regina Sinofsky, the sister of Mr. Kleinman, testified (Tr. 32; App. 115a) that, although she understood that there was an account in her name, her "brother made all the decisions."

The testimony of these persons, to the effect that they had little or no knowledge of the accounts, supports the inference of the court below that Messrs. Drucker and Kleinman, rather than the persons listed as beneficial owners, actually received the profits realized in the controlled accounts. In any event one who violates the securities laws may also be forced to disgorge profits he made for others. See Securities

and Exchange Commission v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1311 (C.A. 2) certiorari denied, 404 U.S. 1005 (1971).

In the light of the foregoing, despite appellants' claim of "wholly imaginative and punitive" profits (Br. 47), it appears that the amounts ordered by the district court to be disgorged were essentially correct. Of the "numerous omissions apparent on the face of the charts" claimed by appellants (Br. 49) there appears to be possible merit only in one instance, where a sale of 3,250 shares by Mr. Kleinman may have been charged to Mr. Drucker (page 64, supra). While we doubt there occurred any "serious mathematical errors" in the computation of Mr. Drucker's profits, (Br. 51), a reconstruction in this brief of the computations from the original records and work sheets of the accountants would involve great difficulty. Because of the apparent error in Mr. Drucker's being charged with sales of an additional 3,250 shares and because Mr. Drucker has sought to have counsel assigned to him on the ground of indigency in a case in which he has recently been indicted, 74/ it does not appear worthwhile to ask this Court to determine the precise amount of his disgorgement at this time. Instead we suggest that this Court now affirm the disgorgement as to Mr. Drucker to the extent of the \$24,500 that he concedes is correct (Br. Ap. I) and to direct a remand for computation of the additional amount of his profits.

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74/ United States v. Robert Drucker, S.D. N.Y. 77 Cr. 596.

CONCLUSION

For the foregoing reasons, the judgment appealed from should be in all respects, affirmed, or, alternatively, the judgment appealed from should be affirmed except that the disgorgement ordered of Mr. Drucker be affirmed only to the extent of \$24,500, and that the case be remanded for determination of how much in addition Mr. Drucker should be directed to disgorge.

Respectfully submitted,

DAVID FERBER  
Solicitor to the Commission

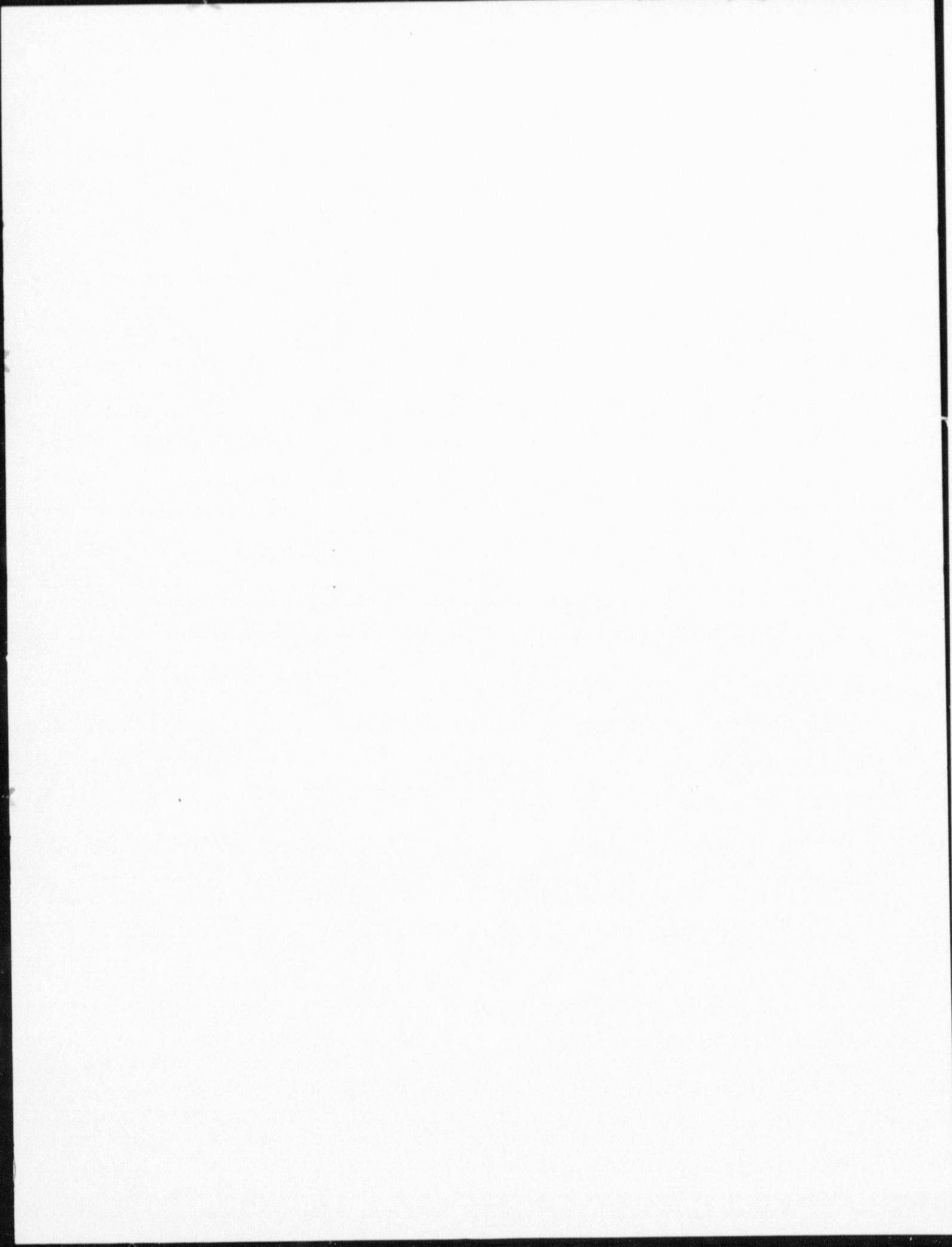
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Securities and Exchange Commission  
Washington, D. C. 20549

August 29, 1977

STATUTORY APPENDIX



Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a) /

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 15(c) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(c)(2)

(c)(1) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive or otherwise fraudulent.

\* \* \*

/ All references to statutory provisions and rules are to those in effect at the time the alleged violations occurred. Subsequent changes to those statutory provisions would not have operated to the appellants advantage.

Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78q(a)

(a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

\* \* \*

## Section 17 of the Investment Company Act of 1940, 15 U.S.C. 80a-17

Sec. 17. (a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12 (d) (3) (A) and (B)), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 21 (b).

(b) Notwithstanding subsection (a), any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of that subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this title; and

(3) the proposed transaction is consistent with the general purposes of this title.

(c) Notwithstanding subsection (a), a person may, in the ordinary course of business, sell to or purchase from any company merchandise or ~~may~~ enter into a lessor-lessee relationship with any person and furnish the services incident thereto.

Section 36(a) of the Investment Company Act of 1940, 15 U.S.C.  
80a-35(a)

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.'

Section 37 of the Investment Company Act of 1940, 15 U.S.C. 80-36

Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 49. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

Section 48(a) of the Investment Company Act of 1940, 15 U.S.C. 80-47(a)

(a) It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this title or any rule, regulation, or order thereunder.

## Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
- (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such

client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

## Rule 10b-5 under the Securities Exchange Act of 1934, 17 CFR 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

## Rule 10b-6 under the Securities Exchange Act of 1934, 17 CFR 240.10b-6

(a) It shall constitute a "manipulative or deceptive device or contrivance" as used in Section 10(b) of the Act for any person.

(1) who is an underwriter or prospective underwriter in a particular distribution of securities, or

(2) who is the issuer or other person on whose behalf such a distribution is being made, or

(3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more other persons, to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution: *Provided, however, that this section shall not prohibit (i) transactions in connection with the distribution effected otherwise than on a securities exchange with the issuer or other person or persons on whose behalf such distribution is being made or among underwriters, prospective underwriters or other persons who have agreed to participate or are participating in such distribution; (ii) unsolicited privately negotiated purchases, each involving a substantial amount of such security, effected neither on a securities exchange nor from or through a broker or dealer; or (iii) purchases by an issuer effected more than forty days after the commencement of the distribution for the purpose of satisfying a sinking fund or similar obligation to which it is subject; or (iv) odd-lot transactions (and the off-setting round-lot transactions hereinafter referred to) by a person registered as an odd-lot dealer in such security on a national securities exchange who offsets such odd-lot transactions in such security by round-lot transactions as promptly as possible; or (v) brokerage transactions not involving solicitation of the customer's order; or (vi) offers to sell or the solicitation of offers to buy the securities being distributed (including securities or rights acquired in stabilizing) or securities or rights offered as principal by the person making such offer to sell or solicitation; or (vii) the exercise of any right or conversion privilege to acquire any security; or (viii) stabilizing transactions not in violation of § 240.10b-7; or (ix) bids for or purchases of rights not in violation of § 240.10b-8; or (x) transactions effected on a national securities exchange in accordance with the provisions of a plan*

ified by such exchange under § 240.10b-2 (d) and declared effective by the Commission; or (xi) purchases or bids by an underwriter, prospective underwriter or dealer otherwise than on a securities exchange, 10 or more business days prior to the proposed commencement of such distribution (or 5 or more business days in the case of unsolicited purchases), if none of such purchases or bids are for the purpose of creating actual, or apparent, active trading in or raising the price of such security. In the case of securities offered pursuant to an effective registration statement under the Securities Act of 1933 the distribution shall not be deemed to commence for purposes of this subdivision prior to the effective date of the registration statement.

(b) The distribution of a security (1) which is immediately exchangeable for or convertible into another security, or (2) which entitles the holder thereof immediately to acquire another security, shall be deemed to include a distribution of such other security within the meaning of this section.

\* \* \*

## Rule 15c2-4 under the Securities Exchange Act of 1934, 17 CFR 240.15c2-4

It shall constitute a "fraudulent, deceptive or manipulative act or practice" as used in section 15(c)(2) of the Act, for any broker or dealer participating in any distribution of securities, other than a firm-commitment underwriting, to accept any part of the sale price of any security being distributed unless:

- (a) The money or other consideration received is promptly transmitted to the persons entitled thereto; or
- (b) If the distribution is being made on an "all-or-none" basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred.

## Rule 17a-3 under the Securities Exchange Act of 1934, 17 CFR 240.17a-3

(a) Every member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange, and every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934, as amended, (48 Stat. 895, 49 Stat. 1377, 52 Stat. 1075; sent the following books and records relating to his business:

(9) A record in respect of each cash and margin account with such member, broker or dealer containing the name and address of the beneficial owner of such account and, in the case of a margin account, the signature of such owner: *Provided*, That, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account.



OFFICE OF THE  
GENERAL COUNSEL

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

November 9, 1977

A. Daniel Fusaro, Clerk  
United States Court of Appeals  
for the Second Circuit  
United States Court House  
Foley Square  
New York, New York 10007

Re: Securities and Exchange Commission v.  
Commonwealth Chemical Securities, et al.,  
C.A. 2, No. 76-6175

Dear Mr. Fusaro:

Enclosed for filing in the above-referenced case are ten copies of the printed version of the answering brief of the Securities and Exchange Commission, appellee.

I hereby certify that I have today caused two copies of the printed version of the Commission's answering brief to be served by United States mail, postage prepaid, upon counsel for the appellants at the address noted below:

Richard W. Lyon, Esq.  
230 Park Avenue  
New York, New York 10017

Sincerely,

*Frederick B. Wade*  
Frederick B. Wade  
Special Counsel

Enclosures